PROCEEDINGS

OF THE SEVENTEENTH ANNUAL

Institute on Accounting

Held at

THE OHIO UNION
THE OHIO STATE UNIVERSITY
COLUMBUS, OHIO
MAY 19 AND 20, 1955

Sponsored by

THE DEPARTMENT OF ACCOUNTING
THE OHIO STATE UNIVERSITY

Edited by

THE BUREAU OF BUSINESS RESEARCH
COLLEGE OF COMMERCE AND ADMINISTRATION

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SIXTH SESSION

FIRST SESSION

THURSDAY, MAY 19, 1955—9:30 A. M.
Ohio Union—West Ballroom

Presiding:

ROBERT L. FLOYD, C.P.A., *Partner, Arthur Young & Company; President, The Ohio Society of Certified Public Accountants, Toledo, Ohio*

Paper: "How Can Federal Budget Procedures Be Strengthened?"

PERCIVAL F. BRUNDAGE, *Deputy Director, Bureau of the Budget, Washington, D. C.*

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WILLARD J. GRAHAM, *Professor, University of North Carolina; Chapel Hill, North Carolina; President, American Accounting Association*

HOW CAN FEDERAL BUDGET PROCEDURES BE STRENGHTENED?

By
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One of the principal aims of the present administration in Washington has been reduction in Government expenditures by economy, greater efficiency and improved methods of operating and budgeting. After the outbreak of hostilities in Korea, the Congress in fiscal 1951 enacted new obligational authority, giving the departments and agencies a check book on which to draw, amounting to $82.9 billion, and the following year—fiscal year 1952—$91.4 billion. New obligational authority has been reduced each year since 1952, and since 1953 has been kept below expenditures and also below receipts.

Expenditures for 1951 amounted to $44 billion, and for 1952 to $65.4 billion. The peak of expenditures was reached in 1953 of $74.3 billion although expenditures for 1954 were estimated in the Budget Message to amount to $77.9 billion. Sharp cuts, however, were made in unnecessary activities, and in personnel, and improved procedures were instituted in many departments, in order to bring the expenditures down.

The reductions in expenditures were used in part, as you well know, for substantial tax cuts, and in part to reduce the budget deficit. The comparative figures for fiscal years 1953 and 1954 and the estimates for 1955 and 1956 in the last Budget Message are as follows:

TABLE I

	Per Budget Document			
	Actual		Estimated	
	1953	1954	1955	1956
Budget receipts	$64.8	$64.7	$59.0	$60.0
Net budget expenditures	74.3	67.8	63.5	62.4
Budget deficit	9.4	3.1	4.5	2.4
New obligational authority for year	80.3	62.8	57.3	58.6
Balances of appropriations carried forward at end of year	78.4	68.0	53.9	49.6

You will note that the budget receipts for 1955 were estimated to be $5.7 billion less than 1954, as a result of the tax reductions which were made last spring.

Our present estimates indicate that 1955 receipts may run slightly higher than our earlier forecast but there will be little change in the budget deficit because of the increased cost of agricultural subsidies. Under the old rigid support legislation these subsidies have cost us each year more than the agricultural experts estimated. I hope that the current Congress will not reverse itself but will give us at least a couple of years' trial of the flexible support program under the 1954 act.

There has been considerable discussion about possible tax reductions in 1956. The income tax rates are still uneconomically high and must be reduced as soon as possible. But I hope that we will not lose the broad base of our present income taxation. It is very important that the largest possible number of people pay income taxes so as to emphasize the high cost of Government operation and encourage everyone to take a personel interest in reducing it.

I understand that over 58 million individuals filed income tax returns in 1954. While we do not as yet have a breakdown by income classes for that year, the 55 million individual income tax returns for 1951 have been classified and 44 million or 80 per cent showed an adjusted gross income of less than $5,000. I am convinced that it would weaken the support for sound and efficient Federal budget procedures if we should exempt small income taxpayers by increased exemptions or by flat amount credits.

A special classification of net budget expenditures was included in our 1956 Budget Document which I have summarized to show the budget totals and the per capita amount as well as percentages to the total.

SPECIAL CLASSIFICATION OF NET BUDGET EXPENDITURES
FISCAL YEAR 1956

	1956 Estimate		
	Budget in (billions)	*Per capita amount **	*Per cent to total*
Cost of operating the Government (Current expenses for civil operations and administration)	$2.3	$14	4
Interest	6.4	39	10
Civil Benefits:			
Veterans	4.5	27	7
Public assistance	1.4	8	2
Other	6.0	36	10
Protection	41.5	252	67
Undistributed (reserves and adjustments)	.3	2	—
Total	62.4	378	100

* Based on Census Bureau forecast of 165 million population on July 1, 1955.

The cost of protection which amounts to $252 per capita for every man, woman and child in the United States and which takes two-thirds of the total tax receipts cannot be reduced as much as we would like because of world tensions and the uncertainties in the Far East. Without the Communistic danger from Russia and Red China, we would have been able to balance the budget before this. It is only because of the valiant efforts of the Administration that we have achieved so large a measure of success.

* * * *

These introductory remarks are intended to outline the magnitude of the problem we are facing. My subject this morning is "How Can the Federal Budget Procedures be Strengthened?" I should like to separate my approach into three separate areas: (1) Preparation and presentation of the administrative budget; (2) Authorization of programs and the obligation of funds by the Congress; (3) Performance by the Executive Branch and its reports to the Congress and the nation.

In any government the size of ours today, it is most difficult to obtain and to maintain control of expenditures. This is particularly true with the variety of our operations and the fact that they are conducted all over the world. But this makes it all the more necessary to do our planning as carefully and as accurately as possible; to work out with Congress simplified and more efficient procedures for the authorization of programs and the granting of funds; and to report to the nation as fully and as simply as possible.

Preparation of Budget

We have already commenced the preparation of the 1957 Budget, that is for the fiscal year beginning July 1, 1956, and ending June 30, 1957. Guidelines are being drafted based on current programs, revised to take into consideration economics, improved procedures, new legislation and policy changes. It has been the practice for some years to prepare for the different departments and agencies ceiling totals which after thorough discussion are used by their respective staffs in the preparation of detailed budget figures.

A balanced budget is still our goal. We hope to strengthen the budget procedures this year by breaking down the ceiling totals into the principal programs contemplated for fiscal 1957, and by emphasizing the necessity for more detailed analysis work initially before the preparation of the detailed figures. Important policy decisions should be reached as early as possible in the budget process. We hope that this will help to balance the budget and at the same time will result in savings in time and expense later on in the fall. We are also planning additional savings through revisions in the procedures for budget review and agency hearings.

Speaking from the point of view of the Bureau of the Budget, we should approach the budget process by the following steps: (1) What are the programs proposed for the budget year and what are their long-range implications? (2) What resources will be needed to carry out the programs proposed? (3) What resources are now available in the form of unused obligational authority, expected earnings or reimbursements, stores and supplies on hand? (4) The extent of new resources needed, i.e., new obligational authority.

This approach to the budget process places great reliance on adequate records and accounting control. In many of the agencies, considerable progress has been made in developing sound accounting procedures but they have not been fully utilized in the budget process. Since expenditures are reported by the Treasury on a checks-issued basis, a reconciliation is needed for the departments or agencies that have adopted an accrual basis. As greater reliance is placed on accrual accounting and adequate program planning, less importance will be ascribed to funding as a control technique. This will still be useful as a control device for inventories and other operations where it has demonstrable advantages. It is not, however, by any means the principal solution of our difficulties. Assistant Secretary of Defense McNeil has used stock funds for administrative control to great advantage, and is inclined to place greater reliance on them than on the more general adoption of accrual accounting.

The responsibility of the Department of Defense and the military services for the protection of this country is such a serious one, and the magnitude of the operations so great that there has been insufficient time for the present administration to revise completely what seem to be extremely complicated and cumbersome procedures. The officials directly responsible are eager for improvements; a number of efficiency experts, management engineers, and accounting firms are presently working out improvements that should result in substantial savings and better management controls.

Developments in nuclear weapons, guided missiles, aircraft propulsion and design, and other aspects of the military art have been so rapid that some waste is unavoidable. We cannot be without defense protection in 1955 just because we think that present models, which are in production, will become obsolete and have to be scrapped by 1957 and 1958. Any lessening in worldwide tension or more definite indications of less aggressive Communist intentions could be converted quite rapidly into important savings in this area. But it is clearly our restored strength which is bringing about a more hopeful international atmosphere. We must not relax or reduce our forces again too rapidly.

We are very fortunate indeed to have in command at this critical time a man as capable, as experienced, and as wise as President Eisenhower. His thorough knowledge of military operations and of the Russians enables him, better than anyone else, to appraise the requirements for worldwide defense of our free Western economy within the reasonable bounds of our capacity. We must be prepared to sustain our defense program over a considerable period of years if necessary. He has elected to make atomic weapons an integral part of our defense system which gives the world on both sides of the Iron Curtain the greatest possible incentive to buckle down and try to work out an effective ban on all kinds of international warfare. It is futile to ban the use of chemical warfare, germ warfare and atomic and other nuclear weapons, and condone other methods of warfare to obtain the fancied objectives of power-hungry dictators.

The President's earnest desire for peace is well exemplified in his appointment of Governor Stassen as his special assistant, in effect "Secretary for Disarmament." Until such time as our efforts in this direction are successful, and probably for some time thereafter, it will be necessary to maintain a strong military establishment.

I am very much in favor of universal military service and I believe that it would strengthen us as a nation as well as giving us better protection at lesser cost. Some day, I would personally like to see every boy and girl, when reaching the age of 18 or on graduating from high school, devote a year of service to our country. There should be no exemptions or deferments, but everyone should be assigned to the jobs for which he or she is best fitted, based on tests of capabilities, experience and demonstrated aptitudes. In my opinion, no compensation should be paid other than uniforms, food, housing, transportation and education. With periodic refresher courses and one or two weeks annual training for the next five years after the term of service is completed, we would have a fine reserve for civilian defense as well as for military requirements. The initial cost in starting the program might be somewhat higher for the first couple of years, but I believe that such a program could be maintained at an annual level substantially below our current expenditures.

Another way to strengthen our forces and reduce over-all expenditures would be to expand NATO into an Atlantic Union of the peoples of the Western Democracies along the lines envisaged by Clarence Streit.

I personally believe that a common defense force of the NATO countries under a single command, using the same weapons, with a common foreign policy and a freely interchangeable currency would bring the Soviet bloc to terms. It would lessen their chance of splitting the West and guarantee a peaceful world at a fraction of the cost of our present voluntary but inefficient cooperative methods. This is my personal belief, not administration policy.

We are moving in this direction at the present time but at a much slower pace than Russian armaments. Their facility in shifting tactics seems to be more adroit than ours. We are in an age which calls for boldness and daring—not caution and timidity. We are an integral part of a shrinking world. We must strengthen our allies, and the more closely we are integrated the more effective our expenditures will be. That is sound budgeting technique.

Another point that I want to make, although it hardly seems necessary, is that sound budgeting calls for reductions in expenditures and economies in operations. This, of course, involves stopping activities and discharging people. Whenever we persuade a department to close a government operation each employee notified seems to call or write his representative and senator and request reconsideration of each action taken or contemplated. I could give you innumerable examples although I hope that you in this Institute are more understanding. One of the reasons for political pressure seems to be the desire of well-meaning persons to be relieved of the adverse effects of necessary decisions. As a matter of fact, terminating Government activities should not result in increasing unemployment. When private business takes over, increased activity should result.

One of my personal projects during the past few months has been to get the Government as rapidly as possible out of activities that compete with private business. This includes such operations as coffee roasting, lumber mills, the manufacture of paint, rope and cordage, fertilizer, rubber, sleeping bags, maps, flags, clothing, aluminum, furniture. The Federal Government today operates over a hundred business-type activities. It is, among other things, the largest electric power producer in the country, the largest insurer, the largest lender and the largest borrower, the largest landlord and the largest tenant, the largest holder of grazing land and the largest holder of timberland, the largest owner of grain, the largest warehouse operator, the largest shopowner, and the largest truck-fleet operator.

Some progress has been made during the past couple of years, I am glad to say, in getting the Government out of some of these activities. The Reconstruction Finance Corporation, as you know, has been liquidated.

The synthetic rubber plants have largely been sold. The assets and operating rights of the Inland Waterways Corporation have been sold. The General Services Administration is placing an increasing amount of its orders with manufacturers, with instructions that they assume the responsibility for storage and distribution to the various Government agencies and branches. The General Services Administration has thus reduced the square feet of space it occupies by 25 per cent since two years ago.

The Department of the Navy has reduced the types of paint it manufactures from 150 to 28. By greater use of commercial warehousing and distribution facilities, the Army is vacating 17 depots containing 39 million square feet of space.

A striking example, however, of what happens when the administration takes a forward looking decision along sound business lines, is the case of the Mississippi Valley Generating Co., more commonly referred to as the Dixon-Yates contract. It is such an interesting story that I am going to relate the facts. It is also directly related to our subject this morning.

The Tennessee Valley Authority was originally established as an over-all project to improve the valley, control floods, reclaim land, provide irrigation and create power by the building of dams and hydrogenerating stations. During the war, for the first time, TVA constructed steam generating plants in order to firm up its power output and to meet the requirements of the Atomic Energy Commission. As of June 30, 1954, so many steam units had been constructed and placed in operation that its total capacity was 6 million kilowatts, 50 per cent of which was hydro and 50 per cent steam. In addition, we had contracted to double the steam capacity by June 30, 1957, to 6 million kilowatt-hours, while the hydro capacity will remain about the same, namely, 3 million kilowatts. This seemed to the present administration to be a very rapid development indeed, taken without due consideration of the proper place of the TVA in the nation's economy—a little boy had become a towering giant. Its total steam capacity already exceeded that of any other company in the country.

All of the steam units had been constructed within the area of the Tennessee Valley. A couple of years ago, however, the TVA requested Congress for authority to construct a unit on the Mississippi River at Fulton. This is definitely outside of the Tennessee Valley. Congress discussed the question at some length and finally rejected the request indicating that a thoroughgoing reappraisal of the TVA's position in the Mississippi Valley would be required. When the request for the construction of this plant was renewed something over a year ago, the administration suggested the exploration of the possibility of obtaining the power from private interests. Under the previous administration, considerable power had been purchased from private interests and two contracts had been placed by the AEC with private power interests; one with a combined capacity of 2.4 million kilowatts to serve the Paducah plant (this was with Electric Energy, Incorporated), and one with the Ohio Valley Electric Corporation for two plants having capacity of 1.8 million kilowatts to supply AEC requirements at Portsmouth, Ohio. Both of these companies were formed by pooling local private utility interests. In negotiating the Dixon-Yates contract, advantage was taken of the past experience in connection with these two previous contracts. It is actually a very favorable contract to the Government and I doubt very much if it could be negotiated today.

The advantages of the contract to the Government are (1) we do not have to borrow more money or ask for an increase in the debt limit to further expand the steam capacity of TVA; (2) the contract is actually more favorable to the Government in certain respects than the two contracts placed by the preceding administration with other private companies; (3) it reduces the overwhelming share of the total TVA production taken by AEC and thereby minimizes the danger of serious over-capacity which TVA might have if the Atomic Energy Commission were to cut back its requirements substantially; (4) it gives both AEC and TVA an additional interchange of power with another private utility system, namely, Mid-South. This could prove very valuable in case of breakdowns or sudden increases in peak demand. TVA already had extensive interchange facilities with the Southern Company.

As a private utility, the Mississippi Valley Generating firm will, of course, pay local, State and Federal taxes. It will also have to pay a somewhat higher interest rate to borrow the money it needs to build the plant. In these respects, the cost will be greater than if the money were borrowed by the U. S. Treasury and advanced to TVA without interest. Aside from these factors, however, the cost is no greater than AEC is already paying for the power it obtains from TVA.

Authorization of Programs and Obligation of Funds by the Congress

Let us now assume that we have prepared the administration's budget and that the President has presented his Budget Message to Congress in January 1956 covering his proposals for fiscal year 1957. When the budget document is prepared, copies are supplied to the appropriation committees of the House and Senate. As soon as the Budget Message has been delivered, the subcommittees of the House Appropriations Committee start their review and hearings at which each of the departments presents its budget request. It is the responsibility and duty of each agency head to deal directly with Congress which will supply the funds, and the Budget Bureau temporarily withdraws from the picture until action by the subcommittees has been completed and the appropriation bills have been introduced, unless the appropriation committees request our attendance.

Currently with this operation, authorizing legislation is being introduced for programs proposed by the administration or by members of the Congress. Before World War II, authorizations, obligational authority and expenditures were closer together in time and amount. There were no large balances of obligational authority carried forward from year to year. This still applies to payrolls and many current expenses but the authorizations, then new obligational authority, and the expenditures vary considerably in the military, foreign and civil works programs largely because of the long lead time required for development and production, and the uncertain world conditions. Various ways of reducing these differences and eliminating the large carry-over of obligational authority have been proposed. This is congressional prerogative but my presentation would not be complete without some comment.

It seems to me that there should be a closer relationship between the obligational authorities voted by Congress, the expenditures and the revenue measures. One way of obtaining the total picture would be to have a single appropriation bill, which would combine the several appropriation bills currently enacted. There should also be some device both in the House and in the Senate for measuring the total appropriations against the estimated revenue before each House takes final action upon an appropriation bill.

There are several ways in which this can be done. One way would be to refer the total appropriation bill after it has been reported by the appropriations committee of each house to the revenue raising committee. Such committees would examine the estimated revenues, propose such changes in the revenue laws as they deem advisable, and prepare a report setting forth estimated revenues under existing tax laws and estimated revenues from any proposed changes in laws. The report would compare the total estimated revenues with total appropriations reported by the appropriations committees and would show the anticipated budget surplus or deficit for the year. The responsibility of the revenue raising committees would of course be confined to the revenue side. They would not have authority to recommend changes in the amounts of appropriations proposed by the appropriations committees. Under this procedure the full membership of each house of Congress would have before it the reports of its appropriations committee and its revenue raising committee on the complete budget picture and would have a better understanding of the probable outcome of the budget before passage of the appropriation bill.

Another practical alternative has been recently suggested. Each appropriation bill would be handled as at present, but after enactment by the Congress would be held without being forwarded to the President for his signature until all the appropriation bills had been passed. A score sheet would be kept to indicate the total appropriations passed by each house. Then an amendatory bill would be introduced which, coupled with the revenue measure, would give Congress a chance to review each of the programs authorized, and decrease or eliminate them but not increase them, before sending all of the bills to the President. Under present procedures many special bills are passed without Congress realizing the impact on the budget deficit. Furthermore, tax reductions have been made independent of the total expenditure estimates.

If some procedure such as that indicated were to be adopted, it should be accompanied, in my opinion, with an item veto for the President. This in effect would give both the Congress and the President a chance to review, and authority to eliminate, items which in the light of the total picture they considered to be unnecessary. If the Congress does not agree with the action of the President, it would, of course, have the authority to pass any item disapproved by a two-thirds majority.

It is the point of view of some of the department heads that too much time is devoted at present to obtaining the authorization and the funds for their operations as compared with the time required for planning and carrying out the programs. The preparation of forecasts, formulation of the budget ceilings, preparation or approval of the budget details and review in the Bureau of the Budget have already been discussed. We are working on improvements and simplifications here. I believe that they can be effected likewise in congressional procedures although this would be for the Congress to propose and put into effect. The heads of the departments must justify their programs before the appropriate committees of Congress both to obtain the authorization and the obligational authority. Since each house operates on its own, this must all be done twice and it does require a considerable amount of time and energy on the part of the top executives in the administration. My experience in business would indicate that few industrial companies would tolerate such a large diversion of time away from operations by their most capable and highest paid executives.

Performance and Reporting

There has been considerable discussion in accounting and government circles about a more universal adoption of accrual accounting and a performance budget.

A joint task force consisting of representatives of the Treasury, Bureau of the Budget and General Accounting Office has been working on the installation of improved systems of accounting and internal control in various departments and agencies. Accrual accounting has been installed in a number of the divisions of Agriculture and Commerce, the Atomic Energy Commission, the Bureau of Reclamation, the Corps of Engineers and several other agencies. It is under consideration by other agencies. The Army adopted a dollar inventory control which has already enabled economies. The Management and Organization Office of the Bureau of the Budget is continually working on proposals for strengthening management control, and its representatives serve on committees such as the Cooper Committee and other interdepartmental committees working out improvements in methods and efficiency.

One of the difficulties of Government service is the complete engulfing of one's own efforts in the vast ocean of Government operations. It is so difficult to evaluate or measure the results of days or years of constant striving towards an objective which seems to retreat constantly and is never fully reached but becomes overshadowed by other developments. Periodic reappraisals, such as that by the Hoover Commission, are therefore particularly valuable. I am sorry that the report of the Task Force on Budget and Accounting has not as yet been released so that I cannot comment on their suggestions.

The Research and Policy Committee of the CED, however, recommended in January an extension of the principle of the program budget, i.e., based on functions and activities of the Government rather than organization units, and suggested that activities be described quantitatively with unit cost figures shown where feasible. Various ways of carrying this out are under consideration and will be tried out. We do not want to increase the size of the already overly large budget document and I feel that constant attention must be given to possible eliminations and reductions in unnecessary detail. I should like to see the detailed listing of personnel in each department eliminated if the appropriations committees would accept as satisfactory total personnel numbers and amounts by departmental divisions and functions.

The regular budget document already serves as a report by the executive branch on its own performance, by programs, for the fiscal year just ended, as well as containing revised estimates for the current year and forecasts for the ensuing year. The Committee for Economic Development recommends that the Bureau prepare in addition a yearly report evaluating the performance showing unit costs plus statistical information and comparisons with other agencies and other years. I am not sure how much would be gained or lost by separating the budget message and performance report but we are exploring the idea. Perhaps something more readable like the so-called Budget in Brief could be developed. This, as you may know, contains charts and illustrations and we try to make it as simple and non-technical as possible.

In conclusion, I should like to return to the thought I expressed in my opening remarks: namely, that the administration's insistence on greater economy and efficiency of operation and improved methods has already had remarkable results, although they do not stand out against the background of such large expenditures for needed programs and military protection. Before I came to Washington a year ago, I was quite critical of the failure to reduce Government expenditures more drastically. I firmly believed, and still believe, in the importance of individual initiative and of the free enterprise character of our economy. But the expansion of all kinds of government had been going on for nearly 20 years. A shift of such major importance and emphasis cannot be made overnight, but will require years of effort. I believe that our Federal budget procedures can be simplified and strengthened. Your own support and encouragement will be of great value.

THE APPLICATION OF DECLINING-AMOUNT METHODS OF DEPRECIATION TO FINANCIAL AND COST ACCOUNTING

By

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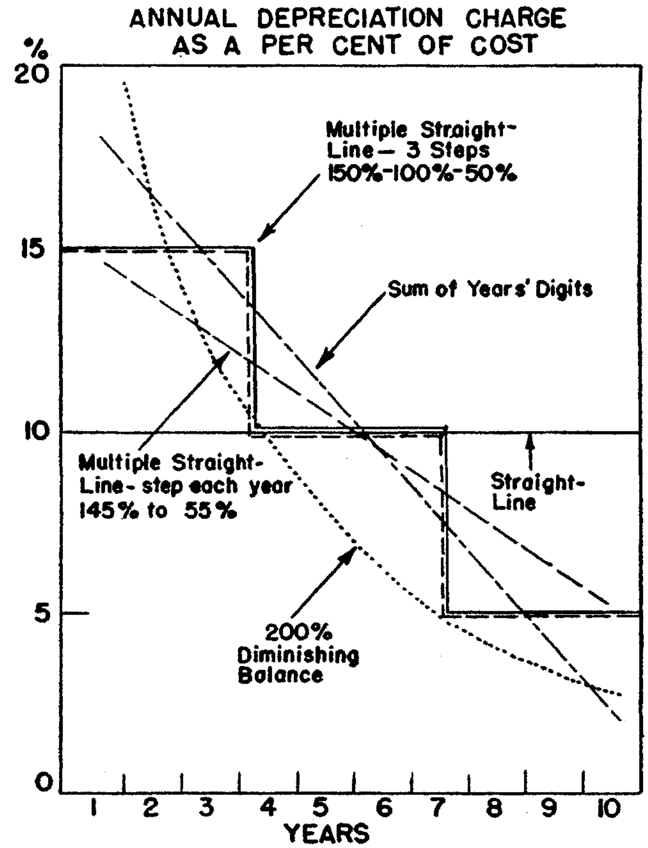
Declining-amount depreciation is not a new accounting concept brought into being by the 1954 Internal Revenue Code. Discussions of this depreciation method are found in most advanced accounting textbooks and in many theoretical treatments on valuation and income determination. Most of these discussions, with a few outstanding exceptions, are limited to two declining-amount methods—fixed-percentage-of-diminishing-value and sum-of-the-years'-digits. That declining-amount depreciation has had such limited application both in business and tax accounting is probably due to its prohibition—practically speaking—in the determination of taxable income.[1]

The broad concept of declining-amount depreciation is not limited to diminishing-balance and sum-of-the-years'-digits. It includes all methods under which more depreciation is written off in the early years of useful life than in the later years. The most extreme example, of course, would be the case in which 100 per cent depreciation is written off in the year of acquisition, thus leaving no charges for subsequent years. Or, double the straight-line rate may be applied each year during the first half of useful life, leaving no charges for the later years. To carry still further the multiple-straight-line-principle, 150 per cent of the straight-line rate can be applied during the first half of useful life and only 50 per cent during the last half. Or 150 per cent of the straight-line rate can be applied during the first third of useful life, 100 per cent during the second third, and 50 per cent during the last third. The ultimate in the applica-

[1] Prior to 1954 the only declining-amount method permissible in determining taxable income was fixed-percentage-of-diminishing-balance, with the initial percentage limited to 150 per cent of the straight-line rate and with no provision for conversion to straight-line in later years of useful life. Under these restrictions, unless substantial salvage value is involved, the relatively small initial advantage over straight-line in the form of earlier write-off is lost soon after mid-life.

tion of the multiple-straight-line method is a constantly declining rate with a uniform change each year.[2] The sum-of-the-years'-digits method is a very specific, formalized, inflexible application of this method.

The point I am trying to make here is that there are an unlimited number of declining-amount methods of depreciation, that the broad general concept includes any method under which the amount of the annual depreciation declines at least once during the life of the asset. The fixed-percentage-of-diminishing-balance method and the sum-of-the-years'-digits method, which are most frequently mentioned in the literature—and



[2] For example, during the first year of life of a ten-year asset, the rate may be 145 per cent of the straight-line rate of 14½ per cent of the cost of the asset. The second year rate would then be 135 per cent of the straight-line rate, or 13½ per cent cost. The third year rate would be 12½ per cent of cost, and so on until in the last year the rate would be only 5½ per cent of the cost.

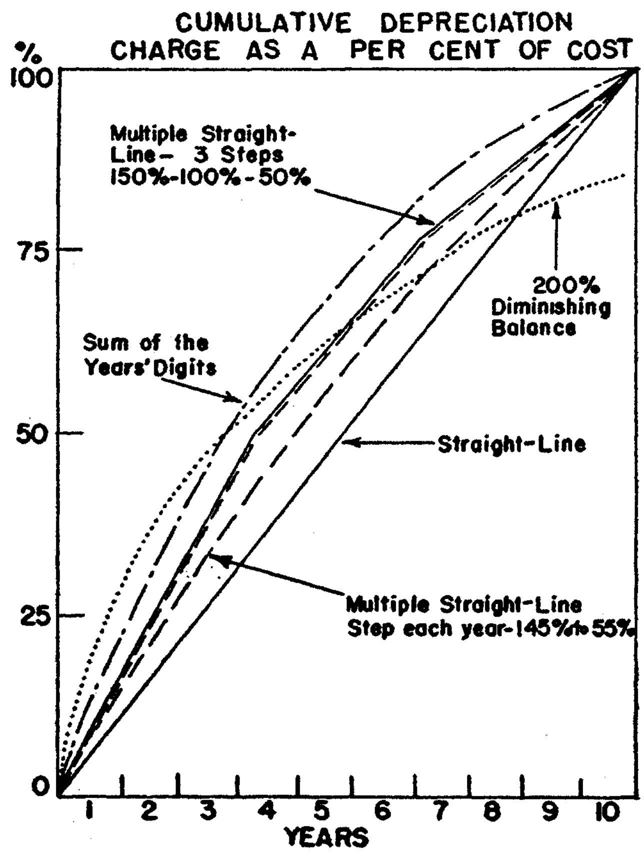
now permissible in the determination of taxable income—are only two examples among many others. The chart on page 16 presents a few of these methods.

Since the enactment of the 1954 Internal Revenue Code there have been hundreds, perhaps thousands, of speeches and articles on the application of declining-amount depreciation to the determination of taxable income. I wish to dispose of that topic very briefly and devote most of my time to its application to the determination of business income and to the development of cost information for management. This subject has not received the attention that it deserves.

In the determination of taxable income, no accounting principles are involved except those which are embodied in the tax law, either explicitly or implicitly. Members of the accounting fraternity urge constantly that accounting principles be incorporated in income tax legislation, and in most but not all cases this represents sound policy. But once the law has been enacted, the problem of determining taxable income is a matter of applying the provisions of the tax law rather than the principles of accounting. The objectives are the lowest possible long-run tax cost and the maximum conservation of working capital. No "principles" are involved; just the achievement of the least and/or latest tax payment possible within the law.

Of course it may sometimes be necessary to choose between the least and the latest payment. If a rate change is in prospect, either by way of a proposed change in the tax law or by a shift in the taxpayer's own bracket, it may be desirable, within the provision of the tax law, to report a larger taxable income now and to pay a larger tax in order to achieve greater savings in the future. For example, maximum deductions in the 1930's when the tax rates were low resulted in much larger total tax payments under the high rates which became effective in the 1940's and 1950's. Should unforeseen emergencies necessitate higher tax rates in the late 1950's or early 1960's, large depreciation deductions now may also turn out to be false economy and result in substantially higher total tax payments over the long period. Furthermore, should an excess-profits tax law be enacted, say in the early 1960's, and the base-income period be, say, 1956–1959, the high depreciation deductions and resulting lower taxable incomes of those years could be very costly. On the other hand, there is the possibility of converting ordinary income to capital gains, if the rate of write-off is greater than the loss of value of the property and a gain is realized at retirement.

It is well known to most of you that under the provisions of the 1954 Internal Revenue Code the taxpayer has the following options. He may continue under the straight-line method for all items of depreciable property, using either the group basis or the unit basis; the government has been urging the use of the group basis. Or, on post-1953 property the taxpayer may shift to a declining-amount method to be selected from the following: (a) The fixed-percentage-of-diminishing-balance method, the percentage not to exceed 200 per cent of that which would be appropriate under the straight-line method; a shift may be made to the straight-line method in the later years of useful life, thus providing for full amortization of original cost. (b) The sum-of-the-years'-digits method, which is applied by writing off a decreasing fraction of cost each year; the denominator of the fraction is constant, being the sum of the numbers of all the years of estimated useful life; the successive numerators decrease by one each year, each numerator representing the number of years of life remaining



at the beginning of the year for which the deduction is being computed. (c) Any other declining-amount method that does not result in a more rapid write-off during the first two-thirds of useful life than does the diminishing-balance method.

Apparently no provision is made under any of these methods for the use of the group basis; retirement losses may be written off as they occur. I shall have more to say on this later.

All of these methods conserve working capital by deferring tax payments, and for tax purposes this constitutes the sole advantage to the taxpayer.[3]

As indicated earlier, this immediate advantage should be matched against the possibility of higher tax rates in the future, or of an excess profits tax with a base-income period coinciding with low taxable-income years.

The balance of this discussion will be devoted to the application of declining-amount depreciation methods to "book accounting," to the determination of business income and of managerial information, with little or no reference to the determination of taxable income.

First, I should like to offer the following as the proper objectives of a sound depreciation accounting policy:

(1) The determination of proper periodic charges against production costs (or costs of sales), properly related to the value of the services rendered by the facilities in successive periods.

(2) An accurate determination of "net investment" or remaining book value: that portion of facility cost properly chargeable against the operations of future periods. This constitutes the proper base to which to relate income in determining percentage return on investment. It follows, of course, that if the first objective is achieved: the proper allocation of periodic charges, the second objective is achieved automatically: the accurate determination of remaining book value.[4]

(3) The development of cost figures appropriate for managerial

[3] A recent survey indicates that most taxpayers who have changed to a declining-amount method have chosen sum-of-the-years' digits. This choice may be influenced to some extent by the fact that it provides automatically for 100 per cent amortization, without the shift to straight-line which is necessary under diminishing-balance. It is unlikely, however, that the more compelling reason is maximum conservation of working capital. The chart on page 18 indicates that after about one-third of useful life accumulated depreciation is substantially more under sum-of-the-years'-digits than under any other permissible method.

[4] This conclusion should be qualified to the extent that for certain purposes the determination of one or both of these amounts might well be based either on replacement costs, or on "adjusted original cost"—original dollar cost adjusted for changes in the general price level. I do not wish, however, to introduce that controversial issue into this discussion.

decisions such as pricing, choice of production methods, choice of products or models, forward planning and other management problems.

(4) Depreciation cost figures and undepreciated balance amounts which offer encouragement to proper retirement, replacement and expansion policies.

With these objectives in mind, let us consider whether a declining-amount depreciation method is desirable for book accounting purposes. May I repeat, no consideration is given here to the method selected for the determination of taxable income. There would seem to be no very good reason for using the same method for both purposes, except possibly that of convenience—the avoidance of "keeping two sets of books." In this connection it should be noted that tax depreciation needs to be determined but once a year, while book depreciation must be determined monthly, and moves into divisional and departmental costs, and thence into production costs. In most situations an annual adjustment of book figures to determine tax depreciation, and a separate determination of losses and gains on retirements, would be a small price to pay for more useful management information and a more accurate determination of business income.

It is quite generally recognized that depreciation is not a method of evaluation of property, but a method of allocating the cost of property to operating periods, then to divisions and departments, and finally to products. The most logical and reasonable basis for allocating this cost would seem to be in relation to the net value of the service rendered by the property in the various operating periods. This leads to the conclusion that depreciation should be on some declining-amount basis, for several reasons:

(1) When property is purchased, particularly when in substantial amounts, it is with the expectation that the volume of production, and the earnings, for the reasonably immediate future will justify the purchase. It is not ordinarily expected that the property will be uniformly useful over its entire estimated life.

(2) The physical efficiency of property ordinarily declines over its useful life, reducing gradually the quantity and/or the quality of its service. This may involve loss of precision, more time out for repairs, and other factors.

(3) There is a gradual encroachment of obsolescence. This gradually reduces the value of even the same quantity and quality of service rendered by the property in successive periods.

(4) Repairs and maintenance tend to increase each year, thus gradually reducing the net value of the service rendered in successive periods.[5]

Additional reasons for a declining-amount method fall into a somewhat different category:

(5) Under the assumption that the long-run trend of prices will continue upward, recovery of larger amounts in early years avoids part of the loss caused by a decline in the value of the dollar, thereby more nearly recovering the economic cost of the property.

(6) While it is reasonably and logically unsound to contend that replacements will be made earlier because of the relatively smaller undepreciated balances resulting under declining-amount methods, experience has demonstrated that in practice a policy of accelerated depreciation does stimulate replacement.

The foregoing seem to constitute cogent arguments for the application of some declining-amount method to book accounting. The specific method to be selected would depend upon the circumstances of a given case. The chart on page 16 shows the operation of five typical methods both in relation to the annual depreciation charge and the accumulated depreciation. With respect to the annual depreciation charge it will be noted that each method starts with a different percentage of cost, declines at a different rate and ends with a different percentage of cost. With respect to the accumulated depreciation it will be noted that the accumulation at the end of each period is different for each method except at the end of the life of the asset; at that point, under each method there has been 100 per cent accumulation, with the exception of the diminishing-balance method. This method, too, can be made to achieve 100 per cent accumulation by converting to straight-line at some point in the later years of life.

In any given situation the method should be selected which achieves best the following objectives: It should reflect best the periodic decline in the net value of the service rendered. It should reflect the most accurate remaining book value—the amount properly chargeable to future years.

[5] There are, of course, many situations where not all of these assumptions are valid. For example, in one of the largest paper companies, I am told the paper machines tend to increase in efficiency for many years after their installation; they produce more paper of a better quality. By constant but not excessive capital improvements (frequently charged to expense!) the encroachment of obsolescence is avoided. In this situation declining-amount depreciation would not be appropriate; indeed, one controller suggests that an increasing-amount method would not be unrealistic.

It should produce the best cost figures for managerial purposes, including replacement policies. Other things being equal, it should involve the least administrative and accounting costs.

A choice of method and the determination of the amount of decline each year involves consideration of the following factors: What services are expected of the asset over the years in terms of volume and earnings? What is the usual trend in the cost of repairs and maintenance over the life of the asset? What evidence is there available as to the decline in efficiency? What can be expected with respect to the encroachment of obsolescence?[6]

Precise and definite answers to the foregoing questions are difficult to determine. But depreciation accounting always involves estimates. In most cases we can be fairly certain that the early years of useful life produce the highest net service value; frequently the first year constitutes an exception because of the cost involved in installation and adjustment, and because of inability to achieve full utilization immediately. In most cases, the last years of useful life produce the least net service value, and the service values of the middle years are likely to be some place in between.

On the basis of the evaluation of the factors discussed earlier, decisions must be made as to the estimated life of the asset(as under any method), the percentage of cost to be written off the first year and the last year, and the frequency of change in the percentage. Finally, and most difficult, perhaps, what should be the rate of change? Should the percentage change at a constant rate as under the sum-of-the-years'-digits method? Should there be a greater change in the early years as under the fixed-percentage-of-diminishing-balance method? Or, should there be a smaller change in early years if that seems more appropriate in a given situation?

It is highly improbable that in any large number of cases the fixed-percentage-of-diminishing-balance method will yield even approximately accurate allocations of facility costs, particularly at the "accepted" rate of 200 per cent of straight-line. The sum-of-the-years'-digits method is particularly inflexible in that both the starting rate and the "slope-of-the-line"—the amount of change each year—are predetermined. But there still remains an almost unlimited choice of specific methods—of first-year and last-year rates, of frequencies of rate change, and the "slope-of-the-line." For example, under the multiple-straight-line method the "slope-of-the-line" may be much less "steep" for buildings than for machinery and

[6] Here it might be noted that George Terborgh, Director of Research for Machinery and Allied Products Institute, suggests the assumption that obsolescence, on the average is incurred at a constant rate each year throughout the life of the asset.

equipment, and less "steep" for some types of machinery and equipment than for others; all depending on the analysis and evaluation of the factors of depreciation discussed earlier.

It is evident that, in any given situation, the selection of the most appropriate declining-amount method and its application, present extremely difficult problems, substantially more difficult than those involved in the application of the straight-line method. But if facility cost ought to be allocated to successive time periods, and to production, in proportion to the net value of the service received in successive periods, and if there is substantial evidence that the net value of the services received does decline substantially over time, it follows that a continuation of the straight-line method of depreciation results in substantial errors in cost allocation. I will hazard the opinion that in most cases these errors are greater than any that are likely to result from the selection and application of any declining amount method that seems reasonably appropriate to the given situation.[7]

[7] The basic assumptions that must underlie straight-line depreciation are these:

(1) The asset is uniformly useful throughout its service life;
(2) There is no decline in physical efficiency;
(3) There is no encroachment of obsolescence; there is no technological progress;
(4) The periodic cost of repairs and maintenance remains constant.

Insofar as these assumptions are not valid in a given situation, it would seem that declining-amount depreciation is more appropriate than straight-line. Furthermore, unless the change in the direction of declining-amount is at least twice as much as it should be—unless the "slope-of-the-line" is at least twice as "steep" as warranted by the facts of the given case—the resulting depreciation charges are still more "accurate" than under straight-line depreciation.

Where a declining amount method of depreciation is used for tax purposes and straight-line depreciation is continued on the books, business income will exceed taxable income at least throughout the "transition period;" perhaps a "reserve for deferred income tax payments" should be created in amounts equal to about 50 per cent of the excess of business income over taxable income. It should be noted, however, that in a large business owning many and diversified depreciable assets, this liability will probably not be "paid" (will not be written off against income tax expense) until the liquidation of the business.

The retention of straight-line depreciation for book-accounting—with the adoption of a declining-amount method for tax purposes—ordinarily demands the creation of a reserve for deferred income taxes. In years when the depreciation deduction for tax purposes exceeds book depreciation, there should be added to this reserve an amount equal to this difference times the effective tax rate, with an offsetting charge to an expense account in lieu of taxes. In years when book depreciation exceeds the depreciation deduction for tax purposes, there should be deducted from this reserve an amount equal to this difference times the effective tax rate, with an offsetting credit to an account which is contra to tax expense.

On individual post-1953 property additions tax depreciation will exceed book depreciation for a number of years and the reserve will increase; about mid-life (depending on what declining-amount method is used for tax purposes) the situation will be reversed and the reserve will decrease; when the asset is finally retired the reserve should be exhausted (subject to changes in the tax rate and to the possibility of capital gains on retirement).

It is contended by some that on *total* post-1953 property additions book depreciation may *never* exceed tax depreciation. The *total* reserve may continue to increase indefinitely—or at least not decrease; the "liability" may never be "paid." Under these conditions why should a reserve be created? In what sense are book profits "overstated" in the absence of such a reserve? In what respects is the payment of income taxes being deferred?

Even more unsound than the adoption of the tax method for book accounting is the restriction of its application to post-1953 assets, as required for tax purposes. It is almost inevitable that grave errors will result from such restriction of the declining-amount method for book-accounting purposes. If a declining-amount method results in a more accurate allocation of facility cost to successive accounting periods, and therefore to products, the method should be applied to all existing plant and equipment regardless of its date of acquisition. This would seem to be sound policy even though its adoption will normally require a retroactive adjustment to the allowance for depreciation and a charge either to retained earnings or to income "below the line."

Let us see what happens if tax practice is carried into the books and declining-amount depreciation, even by the appropriate method, is restricted to post-1953 acquisitions. In order to visualize clearly the effect of this policy it is desirable to assume for the moment a completely "static" operation; by that is meant a constant and uniform policy of replacement each year so that the physical quantity of the depreciable assets remains constant. In order to isolate the effect of other variables it is necessary to assume, too, that there is no substantial change in price levels or in replacement costs.

Under these assumed conditions the application of declining-amount depreciation only to post-1953 assets would result in an increasing annual depreciation charge for a period of years equal in number to half of the average useful life of the depreciable assets. Then the annual charge would decline for about an equal number of years until all pre-1954 assets have been replaced. At this point it would have returned to the original straight-line amount. From that point on the charge would be the same as under straight-line depreciation.[8]

It is clear that at the time of liquidation "book" losses will exceed "tax" losses by an amount equal to the difference between accrued book depreciation (straight-line) and accrued tax depreciation (declining-amount). Insofar as there is any taxable income in the year of liquidation, the "liability" represented by the reserve must be paid. It is equally clear that a business owning a single (or a dominant) post-1953 asset will encounter years past mid-life when book depreciation will exceed tax depreciation, and the "liability" must be paid. It is true also that extraordinarily large property additions in the years just following 1953 may result in larger total book depreciation than total tax depreciation toward the end of the lives of these additions, and the reserve "liability," to that extent, must be paid. Indeed, abnormally large additions in any post-1953 year are likely, toward the end of their lives, to result in larger total book depreciation than tax depreciation, larger taxable income than book net income, and the "payment" of part of the reserve "liability."

It can hardly be said that *any* business is free of *all* of the foregoing contingencies. Under almost any conceivable conditions sound reporting of business income demands the creation of a reserve equal to the tax-rate percentage of the amount by which tax depreciation (declining-amount) exceeds book depreciation (straight-line). The failure to set up such a reserve results in an overstatement of business income.

During this period the allowance for depreciation would have increased to the amount which would have accumulated had the declining-amount method been in operation since the acquisition of the facilities—an increase equal in amount to perhaps 7 per cent to 15 per cent of the original cost of the existing assets. In effect, a transition has been made from an unsound and inadequate depreciation policy of the pre-1954 period to a sound depreciation policy. In the meantime the under-charges of the pre-1954 period have been offset by overcharges during the post-1953 period. From this point on the charges will be "correct" under the new sound policy.

It must be granted that in the determination of taxable income, there is no other feasible method for "making up" the inadequate pre-1954 depreciation deductions. For example, it is obvious that the amendment of tax returns for a period extending back 15, 25 or even 50 years, to the date of acquisition of the oldest asset, would be impossible. Over-deductions in the years following 1953 is the only possible method of allowing for under-deductions in the pre-1954 years, unfortunate as the results of that policy may be in a good many respects. It does not follow, however, that for book-accounting, the only method of correcting pre-1954 errors is by the intentional commission of equal counter errors during a period of 15, 25 or 50 years following 1953 until all pre-1954 assets have been retired.

Departing from our assumed "static" condition to a more realistic condition of continued expansion and growth, we find the same general effect of the restriction of declining-amount depreciation to post-1953 assets. Inadequate depreciation allowances—that is, inadequate under the principle of declining-amount depreciation—are gradually corrected by way of excess depreciation charges. At the end of the transition period—that is, when all pre-1954 assets have been replaced—the annual depreciation charge will have returned to approximately the straight-line charge. In a situation of continued growth, however, the annual charge will remain slightly above what it would be under straight-line.

[8] To illustrate the "hump" in the total depreciation deduction under the tax method, assume the following hypothetical—and admittedly unrealistic situation: All depreciable assets are identical machines which have an estimated, and actual, useful life of 10 years with no salvage value. Each year one-tenth of the machines are replaced with identical machines at a uniform cost. Depreciation is computed at 10 per cent of cost, under the straight-line method.

Beginning in 1954 the sum-of-the-years'-digits method is applied to post-1953 acquisitions. The total annual depreciation deductions, relative to the straight-line amounts, are about as follows:

1953—100%	1957—122%	1961—114.5%
1954—108%	1958—123%	1962—108%
1955—114.5%	1959—122%	1963—100%
1956—119%	1960—119%	1964—100%

Of greater significance, perhaps, is the effect on production costs of restricting declining-amount depreciation to post-1953 assets. Here the results are likely to be random, illogical and confusing, and will reduce substantially the value of cost figures for both managerial and reporting purposes. For example, consider two blocks of similar facilities, one purchased in 1953 and the other in 1954. For the next few years the depreciation charge on the 1954 facilities will be substantially higher, initially as much as 100 per cent higher, than the charge on the 1953 facilities. As the charge on the 1954 facilities declines, at mid-life it will equal in amount the straight-line charge on the 1953 facilities; then, during the next few years it will become substantially lower. How can these costs be comparable for management purposes, or even for reporting? Take another example. Very old facilities almost ready for retirement, will be charged the same depreciation as facilities acquired in 1953, 1952, 1951. If declining-amount depreciation is sound in principle, these cost figures are not comparable. Such a policy would be unfair to divisions or other segments of a business which have predominantly very old facilities—old relative to other divisions which have relatively new facilities acquired in 1953, 1952, or 1951. At the same time divisions which have predominantly new facilities, but acquired before 1954, will have an apparent cost advantage, for a few years, over those divisions with 1954 and 1955 facilities. This apparent cost advantage will revert to a disadvantage in later years. These distortions will reduce substantially the comparability of these cost figures for management purposes.

Finally, the remaining book value—the amount properly chargeable to future periods—is overstated, under the principle of declining-amount depreciation, until the allowance for depreciation gradually "catches up" during the transition period.

Compare this with the situation in which declining-amount depreciation is applied immediately to all existing assets, with a retroactive adjustment of the allowance for depreciation to bring it up to the amount required under the declining amount principle. With this "across-the-board" application, all similar facilities get the same charge for depreciation, adjusted for the age of the facilities. The total depreciation charge against income is in proportion to plant investment, again adjusted for the age of the facilities. Divisions and other segments of the business are charged fairly, allowing for both cost and age of facilities. And, finally, the remaining book value, after the retroactive adjustment, represents a proper estimate of the cost properly chargeable to future periods on the new basis.

Of course there are some disadvantages of "across-the-board" application of declining-amount depreciation. The amount of the required addition to the allowance for depreciation must be computed, and this may be very difficult indeed unless there is easily available the acquisition date of each existing asset. The retroactive adjustment to the allowance requires a charge against retained earnings or against income "below the line." This adjustment may be quite substantial in relation to income or retained earnings. It may amount to as much as 7 per cent or 15 per cent of the cost value of existing plant, or 10 per cent to 25 per cent of its remaining book value. This charge may well be reduced, however, to the extent of perhaps 50 per cent, by setting up a deferred charge in the nature of prepaid income taxes. This deferred charge will be written off against income tax expense in the years when depreciation deductions for tax purposes are higher than depreciation charges for accounting purposes. But severe as the shock may be to income or to retained earnings, if the principle of declining-amount depreciation is sound, then depreciation charges in the past have been inadequate and the retroactive adjustment to the reserve is required to correct past errors.

In a good many cases the full adoption of declining-amount depreciation "across-the-board" will result in higher depreciation charges on the books for the next few years because of relatively large recent acquisitions; of course these will be offset by relatively lower charges later.

Finally, it must be recognized that this procedure creates a substantial gap between book depreciation and tax depreciation, and therefore between taxable income and business income. I do not consider this to be a serious problem. As indicated earlier, the retroactive adjustment can be offset to the extent of about 50 per cent by the creation of a prepaid income tax item. This account may increase in amount in the years immediately following 1953, if depreciation expense on the books exceeds the depreciation deduction for tax purposes. Eventually, however, depreciation deductions for tax purposes will exceed depreciation expense on the books, and in those years the prepaid income tax item can be written off against tax expense. By the end of the transition period, if there have been no changes in tax rates, the prepaid tax item should be completely absorbed. By that time, of course, the allowance for depreciation should be precisely what it would have been had the tax method been followed on the books. From that time on depreciation deductions for tax purposes should be the same as depreciation expense on the books.

A possible alternative to a full retroactive adjustment, but one which I consider to be a compromise with sound principle, can be described somewhat as follows: For book accounting purposes—that is, in the determination of business income and in the development of cost information for management—depreciation is computed under the principle of declining-amount applied "across-the-board," that is, to all existing assets. At the end of the accounting period, however, the depreciation allowance is adjusted to the amount which will reflect accrual under the tax method. The difference between tax depreciation and depreciation expense on the books (including in each amount any loss or gain on retirement) would then appear as a charge or credit on the income statement "below the line," offset to the extent of about 50 per cent by an adjustment either to prepaid taxes or to a reserve for taxes, whichever the situation requires. By the end of the transition period these accounts—prepaid taxes and reserve for taxes—should "balance out" and the depreciation allowance would be at the amount appropriate under the declining-amount method.

It should be pointed out that this compromise eliminates the necessity for a retroactive adjustment but it does not avoid the work involved in applying the declining-amount method to all existing assets. As in the case of the retroactive adjustment, it will be necessary to determine, at least approximately, the acquisition dates of all existing depreciable property. Furthermore, the final net income figure is not correct (although the error is only about 50 per cent as great as under the tax method) and the depreciation allowance remains understated throughout the transition period. It does, however, result in more useful cost information for management purposes and a proper "at the line" income amount.[9]

One unfortunate result of the adoption of declining-amount depreciation is the tendency toward the use of the unit basis of depreciation. It would seem that in many cases the group basis is distinctly superior to the unit basis. Under the group basis each period is charged with depreciation only on the units actually in service, and the undepreciated balance is a proper measure of all remaining useful life, including that of items which will live beyond the estimated average life. Under the unit basis, however, each year of estimated life is charged with depreciation on the items in use plus the loss on retirements occurring during the year. Years beyond the estimated average life receive no charge for the use of items that still remain in service. Furthermore, the undepreciated balance is not a proper measure of all remaining useful life because it includes no amount for items which will live beyond the estimated average life.

[9] Still another alternative to the retroactive adjustment of the allowance for depreciation is to allow the greater gain (or smaller loss) on retirements to compensate for the depreciation deficiencies on pre-1954 assets. This would seem to be even less satisfactory than the first alternative—but better than the tax method.

It is evident, therefore, that for a large number of property items with substantially the same estimated average life the group basis is usually superior to the unit basis. The relative superiority of the group basis depends on the dispersion of actual retirements around the end of estimated average life; the wider the dispersion the greater is the superiority of the group basis. Only in those cases where the dispersion is negligible—where practically all retirements occur near the end of estimated average life—is the unit basis satisfactory. In such cases, of course, the two bases achieve substantially the same results.

While declining-amount methods of depreciation have not applied generally under the group basis, it should be made clear that any declining-amount method can be adopted to this basis, some methods more easily than others. It is necessary only to "straighten the line"—that is, to stop the decline—at some point, and to continue to charge depreciation at that rate, on a straight-line basis, on all items in the group so long as they remain in service.

It is a difficult problem, however, to determine a rate which will be just adequate to make up for the depreciation charges lost on early retirement. Under the straight-line method a depreciation rate which is appropriate under the unit basis is also correct for the group basis. If the average life is estimated correctly, the extra depreciation charges on the units that live beyond the average life will compensate exactly for the depreciation lost on units which were retired early. The incidence of retirements is not relevant so long as the average life has been estimated correctly. Under declining-amount depreciation, however, the adoption of the group basis creates serious complications. It is not enough to estimate accurately the average life of the items in the group. It is essential, also, to predetermine the incidence of retirements—their "timing." Since depreciation charged on the long-lived items beyond the average life is supposed to compensate for the depreciation lost on the short-lived items, it is necessary to estimate not only how many years of depreciation will be lost on the short-lived items, but also at what depreciation rate those years will be lost and at what rate (always lower), the lost depreciation will be "recovered" via charges on the long-lived items.

For example, assume the application of the sum-of-the-years'-digits methods to a group of assets with an average life of ten years. Two items retired at the end of five years would represent the loss of 10 years' depreciation. However, since 73 per cent depreciation has been accumulated on each item, the total depreciation lost, which has to be recovered by way of depreciation on long-lived items, amounts only to the equivalent of 54 per cent of the cost of one item. Compare this case with the early retirement of another item just after installation, at the beginning of the first year. This, too, represents the loss of 10 years' depreciation but in terms of percentage it amounts to 100 per cent of the cost of a single item, and will therefore require for recovery almost twice as many years of life on the part of long-lived items as did the recovery of the lost depreciation on the two items retired at the end of the fifth years, even though the years of the depreciation lost were the same in both cases. It is possible that the difficulties involved in estimating the incidence of retirements may prevent the retention of the group basis under declining-amount depreciation methods, even for book accounting purposes. As indicated earlier, because of the inherent superiority of the group basis over the unit basis, I consider this to be one unfortunate result of the adoption of declining-amount depreciation.

To summarize, in the determination of taxable income, declining-amount depreciation represents a method of deferring tax payment and conserving working capital. Aside from the possibility of higher tax rates in the future, there should be selected from the declining-amount methods available that method which defers tax payments the longest and thereby conserves working capital to the greatest extent. If declining-amount depreciation is merely a convenient device for deferring payments, permissible under the law, it should be used only in the determination of taxable income. On the other hand, if declining-amount depreciation is sound accounting practice and results in a proper allocation of facility cost to successive accounting periods, it should be applied to book accounting—to the determination of business income and to the development of cost information for management.

The restriction of the declining-amount method of depreciation to post-1953 facilities, while required for tax purposes, is not appropriate for book accounting. It fails to recognize and to correct immediately the depreciation deficiencies existing on pre-1954 property. It results in an understatement of net income during the transition period and it produces distorted, illogical and confusing cost information for management. It follows, therefore, that if declining-amount depreciation is sound in principle it should be applied immediately, "across-the-board" to all existing assets, and a retroactive adjustment should be made to the depreciation allowance to correct for depreciation deficiencies on pre-1954 acquisitions. The resulting charge to retained earnings or to income "below the line" should be offset to the extent of about 50 per cent by the creation of a deferred charge in the nature of prepaid income tax. This prepaid item should then be written off against income tax in the transition period, in the years when depreciation deductions for tax purposes exceed depreciation expense on the books. Only by this retroactive adjustment and the "across-the-board" application to all existing property can the advantages of declining-amount depreciation as a method of cost allocation and income determination be made fully effective.

SECOND SESSION

THURSDAY, MAY 19, 1955—1:00 P. M.
Ohio Union—East Ballroom

Presiding:

ROBERT L. FLOYD, C.P.A., *Partner, Arthur Young & Company, Toledo; President, The Ohio Society of Certified Public Accountants*

Presentation of The Ohio Society of Certified Public Accountants award made by Arnold W. Lapp, *Professor and Chairman, Department of Accounting, University of Toledo; and Chairman, Committee on Accounting Education, The Ohio Society of Certified Public Accountants,* to highest C.P.A. candidates in the Fall 1954 examination:

F. JOSEPH RACHOR AND RICHARD W. SHELLENBARGER, of Cleveland

THIRD SESSION

THURSDAY, MAY 19, 1955—2:30 P. M.
Ohio Union—West Ballroom

Presiding:

GEORGE M. FEIEL, *Comptroller, Republic Steel Corporation, Cleveland, O.*

Paper: "Developing Accounting Practices Among Executives"

C. R. FAY, *Vice President and Comptroller, Pittsburgh Plate Glass Company, Pittsburgh; President, Controllers Institute of America, Inc.*

Paper: "Development of Internal Auditing and Its Relation to the Public Accountant"

FRANK W. LENNON, *Assistant General Auditor, The Pure Oil Company, Chicago; President, The Institute of Internal Auditors*

DEVELOPING ACCOUNTING PRACTICES AMONG EXECUTIVES

By
C. R. Fay
Vice President and Comptroller
Pittsburgh Plate Glass Company, Pittsburgh;
President, Controllers Institute of America

Mr. Chairman, Institute members, students, and guests:

I wish to extend thanks both personally and on behalf of the Controllers Institute of America for the honor of appearing here before you. It is an honor indeed, for in 17 short years this Institute has gained national recognition as one of the outstanding annual accounting forums.

We who practice the art daily are well aware of the importance of accounting. This fact was rather humorously brought to mind by a paragraph in a recent column in the *Pittsburgh Press*. Telling about earlier times in the Pittsburgh district the paragraph stated, "Four Livingston brothers, each of whom had a large farm, gathered flour, pork, wool and other farm products in the area with four- and six-horse teams, and disposed of them at the store of their father, Thomas Livingston. The business had no accounting system and after the father died in 1849—at the age of 94—it took 25 years to settle the estate."

Whether an accounting system by itself would have allowed the estate to be settled more promptly the article did not state. However, I am sure that it would have been of substantial assistance.

During the 17 years that this Accounting Institute has been in existence the accounting function has moved ever closer to its proper place in management councils. Those of us here today who are, like Jack Benny, 39 years old, can remember when accountants were bookkeepers and nothing more. We have witnessed the giant strides the accounting art has made. Many factors have contributed to this progress. Among these are the work of groups like this Institute, the continuing efforts of such professional bodies as the National Association of Cost Accountants and the Controllers Institute of America and some of the pioneer accountants associated with forward-looking commercial and business enterprises.

Not only has accounting gained stature from internally-generated enthusiasm by accounting groups, but the very evolution of our economic system has created a deep need for professional accounting and control practices.

If we trace the beginning and growth of our economy we can see how the accountant has exchanged his green eyeshade and unsteady pedestal for indirect lighting and a proper desk. In the early days it was the rugged individualist who set up his own shop and then personally operated all phases of the business. As business ventures grew, they developed a need for money for expansion and American industry saw the era dominated by the banker. As the nation expanded and more products were needed, the production man became kingpin in corporate management. When the economy ran into stiff competition it was the voice of the salesman or merchandiser which prevailed in the management chambers.

In each of these stages the accounting and control functions gradually moved into sharper focus. The banker needed them to watch finances; the production man found them helpful in discovering non-productive areas; the salesmen looked to them for establishing competitive prices. Today the complexities of modern management make the accounting and control functions of paramount importance. Modern management is composed largely of specialists in financing, in production, in selling, and it requires an all-encompassing function such as accounting to keep them all operating cohesively.

When analyzed, ultimately the judgment of management's effectiveness is based upon its ability to operate profitably. I believe that we would be safe to assume that accounting and control factors are today essential in operating profitably, or at the very minimum to determine whether the operation is profitable. On this assumption then, it would seem that the development of accounting practices among executives is no longer a matter of choice. Rather, it is essential.

I am sure you will agree that the one-way street accountants and controllers traveled in the past has been turned into a two-lane highway. We have been familiarizing ourselves with many of the intricate factors of production and marketing. We had to do this in order to perform our functions most efficiently. We have also taken the initiative in developing accounting policies among the production and marketing executives, but I believe there is still much more that can be done.

We must be constantly alert to the problem of how best we can help management secure optimum utilization of the tools which we provide. Fundamentally this is a job of communications. As accountants, the *media* with which we communicate are the reports, the charts, the forecasts and other tools which we fashion from the mass of figures with which we deal. Our method of communication must be to fashion these tools so that they are readily acceptable to, and usable by management. In other words, all the tools in the world are of little value if people do not know how to use them. Ours is the dual objective of making the tools and teaching their use.

Historically, accounting communication was made on a person-to-person basis. As a case in point, take the company I represent, The Pittsburgh Plate Glass Company. In 1883 when "Pittsburgh Plate" was founded, it had one plant, it produced one product, it had a handful of owners, and less than 200 employees. Today it has 34 plants, and 211 merchandising branches with over 30,000 employees making literally hundreds of different types of products. The company is owned by nearly 17,000 share-holders.

When our company consisted of a single plant and produced only one product, accounting and control were simple operations. The head of the firm picked up his hat and went around to see what was what. Because of the nature of the operations, the top executive could supervise practically all phases of the business by direct contact with each operation. As a result, his accounting was relatively simple and his need for controls was minimized. Business in those times operated in a type of hectic *economic frontier* in which each successful businessman was an industrial Davy Crockett.

However, in America's dynamic economy, our company began to grow. New plants were built; new products were made. Ventures were undertaken in allied production fields and into merchandising. Literally a hundred and one new factors had to be dealt with in operating the business.

Our company was only one among many that underwent similar growth. Management in all encountered the same problems. Under increasing pressure, top executives found less and less time for direct contact with the various phases of the operations. Responsibilities had to be delegated to others. Reporting procedures and statements had to be developed whereby costs and expenses of manufacturing, selling and distribution could be controlled. In other words, management had come face to face with accounting policies, the acceptance and development of which was the only logical manner in which they could carry on successful operations. In other words, *control by figures and reports instead of by actual contact* had become a necessity in the nation's modern economy.

Once the important roles of accounting and controls were demonstrated as essential to profitable operation, American business again demonstrated the initiative and competitive spirit which has made it great. There were developed many different means of producing and communicating the accounting data necessary for top management to exercise efficient control. The end results in each method are supported with such details and facts as are required at the various levels of responsibilities. Generally, the controller's department, with its various branches, is charged with producing this data. It is then the task of the controller not only to see that this material is converted into workable "tools" for management, but it is his responsibility to provide whatever guidance is necessary so that these tools are used to keep the enterprise operating in a healthy atmosphere.

Thus, in many respects the controller and his staff may be termed an industrial medical corps whose functions must be both diagnostic and curative. The controller must be able to write out the proper prescription and see to it that the corporate body follows it. In industry the balance sheet, the income statement, the budgets and forecasts are used for much the same purpose as the stethoscope, the cardiogram and the X-ray in the medical field, to find the cause of trouble and then recommend and follow through with an intelligent course of action.

For the controller to be most effective in his role as doctor, he must develop a bedside manner even more persuasive than that of young Dr. Kildare of radio fame. He must be able to get the problem out in the open where it may be examined objectively. Reliance on the diagnosis and the recommended cure must be based on confidence in the controller and the reports prepared by his accounting staffs.

Our goal, then, is one of securing complete, mutual understanding of each problem by accountant and operating executives. I am not proposing that the accountant must have a well-rounded education in all of the specialized operating fields that make up our complex business world, nor am I suggesting that all business executives have a formal education in the field of accounting. However, I will be among the first to admit that even a minimum acquaintance with the basic concepts of accounting practices by operating executives helps lead the way to a more thorough understanding and interpretative analysis of the conclusions derived through the medium of accounting. I am suggesting that the accountant, to be effective, must have a thorough understanding of a problem in order to arrive at an intelligent conclusion. He must also be prepared to convey and sell the soundness of his approach to the operating executive at the same time that he is presenting his facts and recommendations.

As no two fingerprints are alike, no two accounting problems are exactly similar. Business conditions are by their nature highly fluid. The accountant and the operating executive must operate under systems sufficiently flexible to keep pace with a changing business world. In the language of the boxing world both must be able to roll with the punch and find a new offense. Accounting principles and procedures used in one case may be entirely inadequate in another and the accountant must exercise a high degree of selectivity in choosing the best technique to be employed. But with this his job is ofttimes only half done. The operating executive, familiar with only his phase of the enterprise, quite frequently will have alternate plans for arriving at the same conclusions. These must be analyzed, evaluated and weighed against the technique chosen by the accountant.

Under the supposition that the accountant was fully qualified, had an intelligent understanding of the problem and was thoroughly familiar with all facts and figures, the accountant has the opportunity to develop a better understanding of accounting practices *on the spot,* where communication is most effective and where longer-lasting impressions are made. With his specialized training in analyzing figures he can demonstrate how many seemingly extraneous facts all have a bearing on the operating executive's problem.

In large business organizations this job of communication cannot be done by one man. It is basically a team effort. Each man on the controller's staff should be trained to carry the ball. He should look to the controller for signals and support only when the going gets a little rough. This is the way my staff functions and I have found it to be very satisfactory to our policy-making executives, to staff members and to myself.

Operating on this basis, we have found three broad areas in which this continuing program of developing accounting practices among executives may take place. I should like to explore these areas with you to illustrate that applied accounting is dynamic, and therefore, must be as flexible as the many problems we are asked to solve. In other words, I want to demonstrate that in modern accounting we must not be saddled with restrictive practices. I do not mean that we should abandon the fundamental theories and principles of accounting. Rather I am suggesting that we be highly selective in employing the accepted principles and practices to accomplish the best results.

These three broad areas I referred to are: a. *Techniques and Theory;* b. *Planning*; and c. *Control.* In each of these areas where we are working with management we must keep two cardinal facts in mind. The first is that we must give proper guidance, and second, that we must develop complete understanding. Time will not permit a comprehensive discussion of each of these three broad areas but I will try to give you a number of illustrations demonstrating that any program for the development of accounting practices among executives, either formal or informal, must be flexible and continuous.

Now for the first area, the techniques and theory of accounting practices. In almost all companies these have been influenced largely by external factors. These include tax laws, government regulations and stock exchange requirements. These and more must be taken into consideration when developing accounting procedures. Operating executives in most cases would like to be relieved of the necessity of dealing with these technical problems. Yet to operate efficiently all of them must have a reasonable understanding of at least the basic accounting concepts.

Some of the first regulatory measures prompting this need for mutual understanding of accounting concepts arose with the establishment of the Securities and Exchange Commission. Until the advent of the SEC, management had no restrictions from outside sources on how they prepared their published reports, and there were no standards available which would have the effect of requiring uniformity in such reporting. As a result statements of operation were published which included inventory adjustments, varying depreciation charges and reserves which paid more attention to the needs of the profit situation for the current year than they did to the consistent reporting of these items.

All of this has been changed in recent years, and it is now the duty of the controller to keep management abreast of regulatory measures in this field. Equally important is his responsibility of explaining to management the reasons for these regulatory measures and the requirements which they establish.

Pronouncements by the American Institute of Accountants through their research bulletins also have a substantial effect on the preparation of annual reports. A recent example which was extremely difficult to interpret for management was Bulletin 42. This covered the procedures for handling depreciation policy in general but which dealt quite specifically with the accounting treatment of accelerated depreciation, which is allowable under Certificates of Necessity.

The release of this bulletin required a very careful analysis by controllers in relation to their own particular circumstances. In some cases it necessitated development of new accounting procedures which involved lengthy discussions with top management. Because of the many different accounting methods already in use by various companies, considerable confusion existed in the minds of many executives on this subject and the problem of reaching an understanding with top management was an extremely difficult one. However, thorough understanding and agreement between public accountants, the controller and top management was absolutely essential before results for the year could be published.

Equally difficult problems arise with changes incorporated in the Internal Revenue Code. Last year, for example, several new methods of depreciation were added to those which had been permitted under previous laws and regulations. Before the accountant approached management concerning these changes, he had to satisfy himself first as to the advantages or disadvantages to his company of adopting one of the new methods now available. This determination was not an easy one in many cases, for a change in depreciation policy could affect almost every operation of his company, both present and future. Many questions had to be answered. How will the change affect reported earnings? Will the change improve the company's cash position? Should the same depreciation policy be used for both accounting and tax purposes? After he reached his own conclusions, he then had to lay it out for general review and obtain management agreement on the policy to be followed. Following that, he was in a position to implement the policy through his accounting organization.

I should like to point out that in my opinion, the differences between bookkeeping for accounting purposes and bookkeeping for tax purposes are among the most difficult areas in which to develop understanding among executives. We who are in the accounting field can often see very good reasons why certain accounting practices prescribed or allowed in the tax regulations do not make for good accounting practices in terms of our own bookkeeping, even though they may be quite satisfactory from a tax standpoint. Yet there is not always unanimity among controllers and even within the public accounting group on what is good accounting practice. Such differences on technical points are most confusing to operating executives. Yet each company must work out answers to best satisfy its own problems. The controller has an obligation to discuss these matters completely with his own top management, but because of their complexity, should keep his explanations as simple as possible.

As we have indicated before, there seems to be a never-ending stream of new governmental and other regulations flooding the modern accountant. Add to these the details accompanying acquisitions, mergers and sales of properties, and you have some conception of the tidal wave of accounting problems engulfing the modern business enterprise. It is up to the accountant to fashion a sturdy craft in the form of concise and intelligible reports so that operating executives can chart a safe course. To do this the controller and his staff members must try to be many things to many men. But most important they must be expert technicians and effective salesmen. This is the almost impossible job of having the right answer at the right time for the right people.

In the several cases of the application of accounting techniques and theory which I have recited, you have seen that the majority of the programs were initially developed by the accountant and the controller. These programs then had to be explained and sold to top management. In other words, the need or impetus for the fashioning of techniques and theory arose largely from sources outside the company. As was seen in the instance of adopting a new method of accounting for depreciation, this involved several distinct steps by accountants prior to the initial discussion with operating management. These were: (1) *Analysis* of the new method, (2) *Comparison* with the existing method, and (3) *Integration* with company practices. Only when these and other steps were completed could the proposed changes be presented to management. And, it should be remembered, it was only *after* approval by management that the changes in methods became a working part of company accounting techniques.

In the second of the three broad areas where we have opportunities for developing accounting practices among executives, namely: *The Planning Area,* we find that the need arises *within* the company. In fact, action in this field is initiated by top management. Now as never before must operating executives project activities not only months but years ahead. To do this they must have some accurate guideposts to chart the course.

Accountants, therefore, should be and usually are prepared to give substantial assistance to management in the area of planning. However, the controller must obtain the confidence of management that he has the necessary tools readily available and that he *can* be an important factor in the development of the over-all planning program.

The tools the accountant brings to the party are several. The obvious one is that he has the facility to assemble figures and put them together in logical sequence. Another is that he knows what figures are available and how to get them with minimum effort. Also, through his knowledge of the content of available figures, he knows how to use them. By that I mean differentiating between cash costs and book costs, between direct costs and allocated or distributed costs, between variable costs and fixed costs. Further, by his familiarity with the content of figures, he knows whether they contain all they are purported to contain, or whether significant portions of data have been unintentionally excluded simply because figures are being used for a purpose for which they were not originally intended.

These tools are all important to the planning function, yet the accountant will not be used unless operating management is made aware that he does have these abilities and further, has confidence that he does know how to tackle these problems in a broad-minded fashion.

The over-all planning program, of course, includes development of sales and cash forecasts, the use of budgets and other cost estimates and the determination of the effect of these items on profits, the development of the impact of volume on profits, and the effect of earnings forecasts on dividend policy and future expansion of the business.

Planning is also important in relation to capital expenditure programs. One problem in this area has to do with properly calculating return on investment for purposes of supporting requests for the expenditure. In working out such economic justifications, one has to determine what to do with distributed costs in factory expense and with selling and administrative expense as they relate to the departmental or product costs involved. The cost justification of a capital expenditure must relate cash outlay for the equipment against cash savings or cash margin on increased sales. Unless management understands these hard facts, savings estimated in good faith will not be realized when the project is completed. This is a situation in which the accountant can be of real assistance to management through the proper development and interpretation of accurate data.

Since price plays such an important role in planning future operations, the accountant can and should place himself in position to provide much of the data used in price determination. This is particularly true in the case of new products for which actual costs are not yet available. Cost estimates can be deceptive from several different viewpoints. The basic fact that units costs are frequently stated in mathematical terms after elaborate and painstaking calculations, gives them an aura of perfection and reliability which they may not deserve. Cost estimates can be deceptive because of the dangers of leaving out important cost elements or because of hedging too much on production rates or losses, and also because of cost variations which may occur because of variations in potential sales volume. The accountant should be prepared to adjust his thinking and calculations to different volume levels.

But his responsibilities in price determination are not limited to new products. Lest sales management be influenced too much by over-all product line cost and profit data in considering price changes, the accountant should be analyzing and guiding sales management on the impact of variations in product mix, sales volume and technological changes. Mutual confidence between management and the accountant is important here. With all the possible variations in the kind of figure he might produce depending on the use to which it will be put, the accountant should be given the full background of a problem when he is given an assignment—not just the question "What is the cost of a Model B Widget?" By the same token, management will divulge the full nature of their problems to the accountant only when they understand how much information will influence the way in which the accountant approaches the assignment.

Labor relations is another area of planning in which the accountant will be useful. Left to their own devices, labor negotiators can work out with the union some mighty complex agreements which are horrors for any payroll man or insurance man to try to administer. The controller becomes more and more important as an advisor to labor negotiations as we move away from dealing solely with base wages and find more and more so-called fringe benefits entering the settlement. Accounting principles relating to pensions, insurance, vacation pay and other fringe benefits must be reviewed with executives at all levels so that they will understand how these items will be reflected on operating statements and how they will affect the business results both long-term and short-term.

These are only a few of the seemingly endless problems which top management faces in its planning operations. Now we all know that planning for the future depends largely upon knowing what has happened and the correct interpretation of past events. Thus it is obvious that the planning field is indeed a fertile one for the controller and the accountant. We have at our fingertips (or should have), the complete records of what has happened in our companies and in our economy. With these as a basis we should be able to develop material to guide management in planning decisions. As I stated, the controller and his department have raw material and techniques with which to do this. The extent to which these are used depends largely upon three factors. First, the degree of perfection of the technical and analytical skills of the accounting staff; second, the ability of the controller to convice or "sell" management that these accounting tools are dependable; and third, the provision of constant guidance to management in the use and understanding of these tools.

Now the third and last broad area in which we can materially help in developing accounting practices among executives is in the field of control. All of you are, I feel sure, familiar with the progress being made in this field within the profession. Although increasing competition and other economic factors have made top management acutely conscious of the control factor, the basic idea of control as covering *all* phases of operations has not yet been fully accepted. By this I mean that many top executives think of control techniques as being applicable to supervision at lower levels in an organization rather than to themselves. This is probably a logical viewpoint acquired by reason of their administrative duties. Because of this viewpoint, the accountant must adopt a different method of approach in developing accounting practices for getting up control mechanisms than those used in developing the operating plan. To say it another way, many executives believe that the planning function increases in importance as you go up the ladder of management, whereas the control function increases in importance as you go down the management ladder.

This viewpoint is brought out more clearly when you realize that many companies use factory budgets and other expense budgets, but do not have completely coordinated over-all profit controls and financial controls applicable to top levels of management.

Factory budgets are, of course, the prime example of control mechanism. These are the accounting tools used by the foreman at the bottom of the management ladder. He has the least contact with top management planning and also the least personal contact with management at the head office. Yet this is the first place where deviation from the budget or the detailed plan becomes apparent, and where personal attention looking toward corrective action need be taken.

How effective this corrective action may be depends a great deal on the attitude of the foreman to his budget. He must have complete understanding of what the budget represents and what it is supposed to do. And he must have confidence in the budget itself. By this I mean confidence in the accountant who prepared it and a belief that all items included in the budget are actually controllable by him.

This development of confidence between foreman and accountant is not an easy thing to accomplish. The whole concept of budgeting puts the accountant in the position of pointing the finger at the operating people. If the accountant stays in his office and turns out figures, the foreman will naturally be suspicious, both because he has not become well acquainted with the accountant and because he will reason that the accountant cannot possibly comprehend production problems without viewing them on the scene. Actually the accountant may derive more about the manufacturing operation from the figures he sees than the foreman may believe possible, but the point here is that the success of a budgetary control program depends a great deal on how well the accountant convinces the foremen and superintendent that he does understand the manufacturing operation. There is no question but what close contact with the operating problems will enable the accountant to do a better job.

The accountant can minimize some of the suspicions by giving the foreman advance warning of variations from budgets which are developing so that the foreman can prepare himself for the questions of his boss. Further, the accountant can prove his interest by working with the foreman in finding the reasons for these variations. He will also improve confidence by making sure that no mistakes are made on the statements, and that the foreman is not charged for expense over which he has no control. The ideal situation in the education of a foreman arrives when he realizes how each daily operating decision affects increased or decreased costs. Then no costs reported on a regular statement will ever surprise him. The understanding which this implies will breed confidence in the budgetary system, and confidence is the best assurance that the foreman's actions which affect expense will be in accord with the intentions of the budgetary control system.

I have centered most of my discussion on the control concept to the factory level. However, I am not overlooking the fact that many control mechanisms are used by top management and here the controller and his staff at the head office must be even more adroit in getting across the various ideas and principles which are worked into the control mechanisms.

In our discussion of the areas of planning and control I hope I have not overlooked one important point. Specifically this is that both planning and control are less effective when there are gaps in either functions at any level. Also they are less effective when each function is not directly related to the other.

I do not say that these two concepts should be so rigidly tied together that they are completely integrated. But I do believe that there are many instances when they must be linked together to get the best planning and the best control. The accountant is generally in a good position to provide this link through his function of supplying data for planning, and secondly, through his function of setting up the control mechanism for the operation on which he helped in the planning stages.

You will agree, I am certain, that it is prudent to provide for a periodic comparison of the results of the planning function. Such a step is, in reality, a control of this function and is quite helpful to management.

For example, authorizations for capital expenditures, which began as a planning function, should be compared with actual costs of construction.

Eventually the planned return on this investment should be related to the actual return after the new equipment is in operation. Setting sales quotas, establishment of desirable profit margins, and setting minimum requirements for return on investment are several of the many techniques used to control planning and other top management functions.

In our discussion today on this subject of developing accounting practices among executives we hope that we have made clear that there are two phases involved. One is the technical phase. By this I mean that the operating executive must have some basic knowledge of the techniques of accounting. In many instances this knowledge must be supplied by the accountant.

The other phase is concerned more with the guidance and understanding provided executives by the controller and his accounting staff. There might be some question as to which of these phases is the more important.

In my opinion, the latter would seem to offer more possibilities for greater accomplishment. I say this because an executive with a smattering of accounting knowledge could quite conceivably read into a statement something that was not actually there. In view of today's complex business operations this is not an uncommon error.

In this respect I have in mind a statement which we prepare for one of our sales divisions. I asked three different executives what they thought the statement showed. The first one said he thought it showed how much we made on sales to customers. The second said he thought it showed how well the division was able to control its expenses and that the profit variations measured the effectiveness of expense control by the division manager. The third said he understood it to show the amount of money that we made over and above what we could sell the products for in other than primary markets. Actually none of the three were correct. This statement really measured the effectiveness of the division's negotiations with the several manufacturing divisions on the question of what price it would purchase products for resale to its customers.

Many statements are probably being misinterpreted every day by executives who think they know what the statements show. What is more important is that these same executives are making decisions based on these statements. To correct their analysis of statements, the controller or accountant must turn psychologist and guide the executive into seeing reported results in their proper perspective.

As I stated at the beginning of my talk the primary purpose in developing an understanding of accounting principles among executives is to provide a basis of communication—a means to give operating executives accurate, up-to-the-minute facts about their business. As accountants, ours is a difficult task in achieving this objective. We must assume many roles including those of technician, teacher, counselor and psychologist.

But the goal is well worth the effort. As executives become more familiar with the "whys and wherefores" of accounting, they are in a better position to evaluate the important roles of the accounting and control functions. The ultimate result is twofold. It creates a better atmosphere for teamwork between executives and accountants and provides a basis for more intelligent and more profitable business decisions.

In conclusion permit me to emphasize two important points. The first is that this task of developing accounting practices among executives is largely the responsibility of the controller and his accounting staff. And second, it is a continuing responsibility and we must be ever-constant in our efforts if we are to be successful.

DEVELOPMENT OF INTERNAL AUDITING AND ITS RELATION TO THE PUBLIC ACCOUNTANT

By

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Mr. Chairman: Ladies and Gentlemen: I am sure that this week will always remain in my memory as one of the milestones of my life. Just a few days ago I was honored by the election to the presidency of the leading organization of my profession, The Institute of Internal Auditors, and today I have been afforded the privilege to be a speaker at The Ohio State University's Institute of Accounting, which I know is recognized in the field of education and in the profession of accounting as the outstanding university-sponsored program of its type.

This honor bestowed on me today not only brings a natural glow of personal satisfaction, but it grants me an opportunity to be the first to start in motion one of the objectives that our association hopes to accomplish during the coming year, and that is to tell the story of modern internal auditing at locales of learning, to management and to related associations in our profession.

In tracing the development of one's profession it is the usual custom for the speaker to present evidence that such a profession has existed for many, many years. In research for his talk he will refer to the Scriptures and invariably find a character whose work is related to the profession he is expounding. The extremes to which such a process might be carried is best illustrated by my company, The Pure Oil Company, which could advertise its products as being on the market longer than any other in the petroleum industry, for in the first book of Kings, Chapter V, Verse XI, it reads "and Solomon gave unto Hiram 20,000 measures of wheat and 20 full measures of *pure oil.*"

In my discussion this afternoon I do not intend to give a detailed dissertation of the development of internal auditing; I shall only cover enough of its history and background to afford an entree to that which I believe you are more interested, and that is: What are the latest concepts regarding its function?

In tracing the development of internal auditing and its place in history one naturally associates it with the progress of accounting, as it was in the auditing of this function that the first internal auditing unit as a separate staff was established.

Accounting, as we all know, goes back several centuries; its utility was enhanced with the Industrial Revolution, but the full impact of its significance did not come about until the beginning of our present century.

The great strides that have been made in scientific research, the development of mass production systems in industry, and the extent of greater government influence in the affairs of business through taxation and regulation during the past 50 years have resulted in overwhelming demands on those in the accounting orbit. This tremendous expansion, with its consequent decentralization of physical properties and management, made it extremely difficult for the echelon at the top to maintain the control and knowledge of operations that were necessary for effective and sound administration. It was during this period that accounting came to the foreground and became one of the most effective tools in management control.

Concurrent with this expansion in our economy since the turn of the century, we naturally find an increasing number of people making equity investments in business. This increasing diversification of ownership coupled with the fact that our economy was moving from one of rugged individualism to one of laws and regulations gave considerable impetus to examination by independent public accountants.

It is when we begin to review the history of the public accountant since the beginning of the century that we find the emergence of the internal auditor. In the first part of the century we find the public accountant being known as a super-sleuth, for it was during this time that a great part of his audit program was devoted to detecting fraud and embezzlement. And, it was during this time that we find the inauguration of internal auditing as a separate staff function.

With industries growing in size and number it became impossible for the public accountant to give a coverage comparable to that of the past and still keep his fees within a reasonableness acceptable to the entrepreneurs. It was then that management made its decision to have some auditing done from within. This decision was not based on a matter of economy alone, for operations were beginning to expand and grow at such a pace that management felt that the protective service it desired would be more effective if it were performed on a more intimate and continuous basis.

At first blush one might conjecture that this move by management would be resisted, or at least not encouraged by the public accounting profession, as its natural result would be the curtailment of their audit program. This was far from the case, as the independent accountant took a realistic approach to the establishment of this new staff form of internal control—in fact, in many instances such staffs were established as a result of their recommendations. Parenthetically, I do not believe that the gross of our public accounting friends decreased as a result of this move, as it was at this time that their services became increasingly in demand in the field of federal taxation.

And so we find the emergence of the internal auditing function as a separate staff during the first 15 years of this century. From the background given we see it performing in an orbit that is primarily concerned with fraud and defalcations. We also see that its performance is similar to that of the public accountant in that it confined itself to reviewing only accounting and treasury department functions. Because this beginning approach was similar to the independent auditor, we find many of the early internal auditing departments staffed with men who had previously been employed in public accounting.

This beginning or public accounting approach reflected itself in particular emphasis being placed on those areas involving cash, receivables and inventories, where defalcations were more likely to occur. The type of reports rendered to management were even similar to those prepared by the public accountant in that they included a letter of transmittal, financial statements and exhibits, summary of operations and comments concerning the individual assets and liabilities.

This public accounting or balance sheet type of approach continued for a number of years until those in the profession began to realize that within the area in which they operated a much broader service than mere verification of accounting and treasury functions could be rendered to management. Auditing departments had begun placing on their staffs personnel that had been employed within the company for several years. The merging of their experience and knowledge of company operations with those on the staff that possessed appraisal and audit techniques afforded them an opportunity not only to verify accounting and treasury department functions, but to appraise them from a management viewpoint. This significant trend which was evidenced in some companies in the late twenties and thirties was fostered and further developed by the Institute of Internal Auditors.

Although some of the large companies had developed their internal auditing to a fairly high standard prior to the organization of the Institute in 1941, it was not until the unified effort of those in the profession began expressing itself through this association that we find a crystallization of the concepts of the internal audit function. I also like to think, and right-fully so, that it was the influence of the collective action of the members of this great organization that brought about the evolution of modern internal auditing.

This evolution begins with the breaking away from the public accountant's approach to internal audit assignments. The principle of verification, which is employed by public accountants, was still retained, as the internal auditor recognized that management expected from him a service that would safeguard the company's resources from theft and fraudulent transactions; but in addition to this protective service the examination was extended to render a constructive service that management could use in effecting a more efficient administration and operation.

Under this new approach the internal auditor became as much interested in the manner in which things were being done as in the end results themselves. He not only verified the authenticity and validity of a charge, but began using his broad knowledge of company operations to challenge its amount and necessity. He began auditing for profit, and became just as much interested in internal controls to eliminate waste and inefficiency as in those maintained for the detection of defalcations and fraud.

It is in the emphasis that is placed on the constructive as compared with the protective service of the audit function that we find the basic difference between internal auditing and public accounting. To illustrate this point let us take the broad subject of internal control.

The American Institute in its bulletin on the subject in 1949 defined internal control accordingly: "Internal Control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies."

The bulletin goes on further to state: "This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a system of internal control extends beyond those matters which relate directly to the functions of accounting and financial departments."

This statement by the American Institute, in my opinion, is a commendable one, and one in which I am sure the internal auditing profession as a whole is in full agreement, for in practice we find the internal auditor extending his responsibility to cover practically all controls established by management; in fact his responsibility is so clear in this area that it was included in the definition of internal auditing in a statement published by the Institute of Internal Auditors in 1947 under the title "Responsibilities of the Internal Auditor." I quote: "Internal Auditing is the independent appraisal activity within an organization for the review of the accounting, financial and other operations as a basis for protective and constructive service to management. *It is a type of control which functions by measuring and evaluating the effectiveness of other types of control.*"

In his review the internal auditor will not only be interested in whether internal controls are established and their underlying procedures are being followed, but he will be equally as interested in whether they are economically sound and worthwhile.

With reference to the public accountant, his responsibilities in respect to controls will vary with the purpose of his engagement. On most assignments, and on all where the purpose is merely to give an opinion concerning the financial statements, he will only concern himself with those controls that have a bearing on safeguarding the assets of the business and of affording a check on the accuracy and reliability of accounting data. The examination and review of such controls does not include a challenge as to whether they are actually worthwhile, but is done for the purpose of determining their existence and effectiveness in order that he may justifiably rely upon them in developing an audit program that will place him in a position to give a professional opinion.

To further elaborate on the difference between the stricly verification or protective service versus the constructive service to management, I should like to give some illustrations pertaining to cash, accounts receivable and merchandise.

In the audit of a large cash working fund that has a fixed balance of $100,000, but whose monthly clearances are several times this figure, the auditor from a verification standpoint would be interested in the adequacy of internal controls, signatures, approvals, bank reconciliations, certification from the bank, etc. However, extending his examination into the constructive area, he would develop information concerning the excessiveness of the fund which was resulting in unnecessarily tying up resources of the company, or its inadequacy which was resulting in an inordinate number of reimbursements and heavy bank service charges. He might also even consider the feasibility of discontinuing the working fund account at this location and suggesting a procedure that would permit the drawing directly on a general bank account of the company.

In the realm of receivables the protective approach would be primarily concerned with the verification of balances, a test check of charges and credits and a study of the accounts to determine collectability. In addition to these phases the constructive service would include a thorough study of exceeded and unauthorized credit, and an attempt to determine whether the condition was due to an unrealistic credit policy or to the fact that the sales organization was disregarding prudent credit extension in order to increase sales. The constructive type of audit in this area would also include a study of the ratio of credit memorandums to total charges made, and if out of line, determine the cause, whether it be errors in billing, customer dissatisfaction with quality of merchandise, or allowances granted because of damages due to faulty packaging, etc. It would also include an examination of the file on complaints made by customers and a summary in the report on any particular category that appeared to deserve attention. In his examination of such complaint file the auditor would be interested in whether a system for handling had been set up that resulted in prompt and courteous attention. Yes, the interest of the internal auditor in this area goes far beyond the verification of account balances; it goes quite deeply into factors dealing with customer and public relations.

And now for a specific illustration regarding merchandise or any other commodities that may be placed in storage. From a strictly verification or protective approach an auditor would be quite satisfied if he found a good system of internal control which included proper custody of the stock and the maintenance of a perpetual inventory record. The auditor, who in addition was rendering a constructive service to management, would be far from being satisfied if he found that this costly perpetual inventory system was being used when 90 per cent of the stock constituted only 10 per cent of the value.

One of the noticeable changes that came with the breaking away from the public accountants or the stricly verification approach was in the form of internal audit reports. Prior to the establishment of the Institute of Internal Auditors in 1941 most internal auditors were rendering reports to its management that were quite similar to the long form of reports issued by public accountants. It included, as previously stated, a letter of transmittal, summary of operations, analysis and comments on scope and findings in respect to the individual asset and liability accounts, exhibits and schedules, and quite frequently even an opinion.

This type of audit report became the subject of challenge by many of the leaders in our profession. Studies and inquiries presented convincing evidence that management purposes were far from being served by this type of reporting. Research on the subject revealed that:

1. Management was not relying on the audit reports to summarize

and analyze the operations of the company. It was receiving such information and other financial data currently from its accounting and other control departments.

The inclusion of such already known information was not only unnecessary, but it had the additional disadvantage of making the report so voluminous that it discouraged a proper review by the parties to whom it was directed.

2. Inclusion of scope of audit in the report in respect to various asset, liability, income and expense accounts was nothing more than additional verbiage.

   Management which is not versed in the accepted practices in the profession is in no position to determine the adequacy of review under the varied circumstances that are encountered. It was felt that the scope of the examination was the primary concern and responsibility of those supervising the audit and its inclusion in most reports served no useful purpose.

   It was further determined that the reason and necessity for defining scope in an audit conducted by a public accountant did not exist when performed by an internal auditor who is not confronted with legal liability.

The changes and advances that have been made in reporting are to render a narrative form of report based primarily on the principle of "reporting by exceptions." Studies have indicated that management wants a report that will reflect three basic things:

1. What is being done that is contrary to accepted principles and policies that have been formulated by management.
2. Whether the policies and directives of management are measuring up and are promoting the general good of the company in their everyday applications.
3. Recommendations and suggestions of how things that are being done may be done better.

In this type of reporting, statistical information and schedules of financial data are only included if they are necessary to illustrate or substantiate a position taken therein.

The changes in perspective by the internal auditor that carried him beyond the area of verification and into the field of constructive services to management brought with it the origination and appreciation of what we in the profession designate as the functional type of auditing. This type of audit is basically different from what is termed a responsibitly audit. In a responsibility audit the auditor covers in a general manner all the matters within the jurisdiction of a certain department, whereas on a functional audit he concentrates on a particular phase within the responsibility and makes a very extensive examination and appraisal of it. Such examination may be confined to a phase within a single department or division, and again it may have greater value in determining weaknesses in internal control and unnecessary duplications if it is extended to cover the company as a whole. Such types of audits could cover cash receipts, cash disbursements, payroll, wage incentive plans, shipping and invoicing controls, and many other specific functions of the business.

The technique used in the functional type of audit has lent itself to a trend that is currently gaining momentum in the profession, and that is of the internal auditor extending his review and appraisals into non-accounting areas. Although there are those that might challenge this move, it appears to me to be nothing more than a logical step in the progress of the profession, and it is the intention of our national organization to give it full encouragement. A high caliber internal audit staff with its proficiency in review and appraisal techniques and its broad over-all knowledge of company operations is certainly qualified to review policies, procedures and controls in many non-accounting areas such as purchasing, taxes, traffic, insurance, etc. Management that fails to utilize the services of the internal auditor in such fields is not affording the audit function an opportunity to operate at its maximum utility.

* * * *

A discussion of the development of internal auditing would not be complete unless we reviewed the age-old question, to whom shall the internal auditor report?

A review on this subject takes us back to the position taken a number of years ago by the public accountants who contended that a greater independence of the internal audit function would be realized if the internal auditor reported to an executive other than the chief accounting officer. Although this position resulted in several companies making changes, we still do not find a fixed pattern. In the last study made on this subject by the Institute we find that out of 270 replies received to a questionnaire, 125 were reporting to such officers as treasurer, vice president, president and chairman of the board; 119 to the controller; and 16 to the board of directors.

Because responsibilities under given titles differ in various companies, the Institute has never gone on record as attempting to designate specifically the officer to whom the internal auditor should report. It has taken the general position that the head of the internal auditing department should be made responsible to an officer of sufficient rank in the organization as will assure adequate consideration and action on the findings or recommendations.

Assuming that such person has sufficient stature to have effective action taken on audit findings, I feel that the internal auditor should report to the vice president of finance or to an officer holding a comparable position. This would satisfy those that have very strong feelings that an accounting executive should not administer the audit function, but more important to me is the fact that in this era of increasing the usefulness of internal auditing the auditing department would be functioning under an executive command that could direct it into any department or division of the company.

* * * *

In reviewing the development of internal auditing it was necessary to allude to the difference that exists in the perspective between the internal auditor and the public accountant. Basically, we found that the public accountant was primarily concerned with following a program of verification that was sufficient in scope to place him in a position to give an opinion, whereas the internal auditor performed certain verification work to fulfill a protective service to management, and in addition, supplemented its activity with constructive services that would be useful to management in discharging its administrative and operating responsibilities.

To compare the utility of the two types of audits would be quite difficult—in fact in my opinion it could not be satisfactorily done, as their ultimate purposes are so different. The public accountant, because of the nature of his assignment, is more interested in the verification of results than in the manner in which these results are obtained; consequently, the manner in which he goes about his examination will be quite different from that of the internal auditor who is not only interested in the end product but in the validation of the processes from which the results were obtained. The perspective of the two are also influenced by the fact that one through his complete independence is rendering a service to the general public, while the other's major objective is to be of maximum utility to management. Operating to a large extent in the financial and accounting areas, but with different perspectives, they both find the necessity of their existence in an economy where widespread ownership exists and decentralization of operations and management are the order of the day.

* * * *

Do the basic differences in the approach of the external and the internal auditor preclude any collaboration between the two in accomplishing their objectives? Of course the answer is no, for in the verification process for rendering protective service to management the internal auditor will be working in the same field that will be traversed by the public accountant. It is in this area that many unnecessary duplications exist which could be eliminated if a closer liaison and understanding existed between the two. Management can be instrumental in effecting this understanding by initiating a conference between the two prior to the commencement of the independent examination. This conference should afford an opportunity for them to come to an understanding that will result in the dovetailing of their scheduling and programing to eliminate all unnecessary overlapping.

In the orbit of collaboration it is only natural that a closer understanding between the two auditors will exist if an appreciation as well as a comprehension exists between them concerning their differences of approach and purpose. A fallacy that both could be guilty of would be in the presumptuous thinking that either side was serving a greater cause. Collaboration with one another will never exist on a senior-junior type of relationship. The quality of personnel we now find on internal audit staffs and those employed by public accountants are of equal caliber and intelligence, and recognition of this fact is of no little importance in endeavoring to develop a program of collaboration.

There are many feasible ways in which this collaboration may be effected; however, I will limit myself to an important one, and one in which I believe greater results would be achieved through collaboration than if the subject were examined independently, and that is the review of internal control as applied to accounting and financial departments. This broad subject would be a natural for a team composed of an internal and an external auditor. One could bring to the project a know-how of company organization, procedures, operations, personalities, etc., while the other could bring the valuable experiences gathered on several similar engagements in various companies. This important area has great possibilities in the realm of collaboration and it definitely should be explored by members of both professions.

And now while on this subject of collaboration, ladies and gentlemen, I shall collaborate with your innermost thoughts, and sit down. Thank you very much for your gracious attention.

FOURTH SESSION

THURSDAY, MAY 19, 1955—7:00 P.M.
Ohio Union—East Ballroom

Presiding:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Paper: "Electric Power, Productivity, and Our National Welfare in the Two Decades Ahead"

PHILIP SPORN, *President, American Gas and Electric Company, New York, New York*

Presentation of Accountant to The Accounting Hall of Fame

ELECTRIC POWER, PRODUCTIVITY, AND OUR NATIONAL WELFARE IN THE TWO DECADES AHEAD

By

PHILIP SPORN

President, American Gas and Electric Company, New York

Dean Weidler, Distinguished Guests of the Institute on Accounting, Members of the Student Body, Ladies and Gentlemen:

If it seems odd to address a body of accountants—students, professors and practitioners—on electric power, let me first assure you that I am not going into an esoteric discussion of power and its technology and I am going to stay away from the most intricate phase of the subject, without which no talk on power seems to be complete today. I mean atomic power.

We all know the pervasive character of power in a modern industrial society. Electric energy enters into every step in any representative industrial process. The need starts with construction of the production plant and continues in increasing amounts until we end up with permanent operation of the project at a control center. The industrial operation may be one using negligible quantities of electric power, as in the case of manufacture of wearing apparel. It may use very heavy quantities of electric energy as in production of aluminum or magnesium. But no significant industrial operation can be carried out without some definite amount of electric energy.

And to a considerable extent the same thing is true in the homes, on the farms and in the commercial establishments. Without electric power a good many of today's indispensable operations in these areas of work or living would not be possible. Without electricity, the $25 shaver which in the course of a year consumes about one kilowatt-hour of electric energy is just about as useless an item as the AEC's 1.4 billion diffusion plant in Pike County, which will use more electric energy than the City of New York.

I want now to analyze more closely the role that power plays in our economy. What is its place in determining the productivity of an industrial society? Among the most important factors in the high productivity of the United States are these two:

1. The large industrial plant that is available to every worker engaged in industry, and

2. The large amount of electric power that is available for operating the industrial plant; or to put it another way, that is at the beck and call of every worker engaged in operating the industrial plant.

Ever higher productivity is critically important in the United States in the light of expected population growth over the next two decades. It is now generally accepted that in the next 20 years we will have a growth in population of close to 60 million. This 40 per cent increase in population, it is now also generally agreed, will be accompanied by an increase in labor force by about 20 per cent, and an increase in the hours worked of well below 10 per cent.

How will this additional 60 million be taken care of—raised, educated, fed, clothed, housed and entertained at the higher living standards we expect to prevail within 20 years, and with only this modest increase in labor working hours? The answer is increased productivity by more intensive use of tools, equipment and electric energy.

There is a close relationship between productivity and increased use of electric energy, and it can be measured by two indices, the FRB Index of industrial production and large light and power sales of electric energy. Historically, use of electric energy in industry has increased at a much more rapid rate than the FRB Index. This appears dramatically from a comparison of the large light and power sales per point of the FRB Index over a period of years.

A careful forecast of the FRB Index of industrial production for 1975 gives a figure of 245. That is nearly twice the 1953 figure of 134, but I do not believe that that is overly optimistic. In the same period the number of production workers in the country, which in 1953 was close to 14 million, is expected to increase to nearly 17 million. However, our studies indicate that the man-hours worked will increase during the same period only a modest 8 per cent. Obviously then, the sharp increase in the FRB Index has to come about as a result of the greatly expanded output of the average worker. The measure of this is seen in the nearly tripling of large power sales per point of FRB Index: Whereas the 1953 figure was $1{,}400 \times 10^6$, we believe the 1975 figure will approach $4{,}000 \times 10^6$.

The sum and substance of this is that the 1975 worker, with fewer hours on the job than his counterpart in 1953, will be much more productive and he will require a tremendous increase in the amount of electric energy he makes use of per man-hour he works. While the 1953 figure was 9 kilowatt-hours per man-hour, in 1975 it will be very nearly 35 kilowatt-hours per man-hour.

So, power is going to be critically important in bringing about the higher productivity which we must get to support our growing population. But we must also keep clear that the prime mover in our coming development is going to be the increasingly large industrial plant that we are going to create and the skill that we have developed in its use. And behind plant and skill, behind tools and technique, are the freedom and enterprise that have brought our industrial complex into being, and that make possible its further expansion. Of course the tools of industry will have to be powered by electric power; without power they will not operate.

So that we finally come to this: while power is an indispensable factor in our industrial system, it is at the same time only one such factor in the elaborate array of resources, human and material, which must be combined to achieve and sustain the high standard of living which we enjoy and which our entire population enjoys today, and which we are confident our greater population will enjoy at a higher level two decades hence.

I feel the need to underscore the point that I have just made. It is surprising how much misunderstanding exists as to the true economic role of electric power in most industrial operations. As I have suggested, power is a critical factor if it is absent, but it does not follow, as many speakers and writers would have us believe, that given electric power all else in our economic system follows as a matter of course.

A study that I made only a few years ago, but which I think would yield similar results today, gives further point to this observation. In this study an analysis was made of the energy utilized, cost of electric energy and the percentage of cost of the energy, to the total value of product for 20 major industry groups. Excluding the electrochemical and electrometallurgical processes where electric energy enters into the process so as virtually to become a raw material, the results showed that electric energy represents less than 0.8 per cent of the value of the product shipped.

I have gone into this matter of the role of power at some length because in some quarters it has come to be taken for granted that abundant power is the sesame to prosperity and well being, and therefore the government must be interested in power development as the sine qua non of a flourishing industrial economy. However important power may be, such a view is both an exaggeration and a distortion, bound to produce confusion in thought and in action on the subject today, and to an even greater extent, in the years to come when atomic power may become a much more important factor in our power economy.

Power being the important element that it is, but with its role clearly understood, you may be interested in knowing how well we have done in this country in making power available to the degree that the country has required. In the period 1920 to 1952, you will find that the population of the United States increased roughly 50 per cent, from just over 100 million to more than 150 million. In the same interval production of electric energy increased 8-fold, from just under 60 billion kilowatt-hours to more than 460 billion kilowatt-hours. And the kilowatt-hours available here to every man and woman went up 6-fold from slightly over 500 per person in 1920 to nearly 3,000 in 1952. Today the United States accounts for over 40 per cent of world production of electric energy and we are still expanding our power facilities as fast as any nation in the rest of the world. Since close to 80 per cent of the electric power in the United States is produced by private power, I think it no boast to say that the private power industry is doing a fine job in the United States.

A natural question to ask at this stage is how much electric power are we going to have to use in the next two decades? If we are going to have to deal with a population increase of the order of 40 per cent; and if it will take the increases in productivity that I have mentioned to keep this expanded population on the level of welfare that we visualize; and if it will take the large increase in industrial plant and in the power to drive it, to give this population the productivity necessary to support it, how well equipped are we to supply all this additional power?

To answer these questions it is again necessary to resort to the FRB Index of Industrial production. I have suggested the value of this index for 1975 as 245, and the value of kilowatt-hours per man-hour of 35. If you then add to the industrial requirements for kilowatt-hours all the other uses of electricity necessary for a balanced economy, you come out with a staggering energy requirement for 1975 of over 2,000 billion kilowatt-hours. This compares with the 1954 figure of some 475 billion. The capacity required to generate and furnish this huge block of energy is 425 million kilowatts, against the capacity of some 104 million kilowatts available in the country at the end of 1954. In other words, in this two-decade period the capacity of the country's utilities will have to be quadrupled.

Can the power facilities of the country be expanded in this fabulous fashion over the next two decades? Can such systems be brought into being physically? Can they be financed and operated successfully, both from the functional and economic viewpoint? By the latter I mean can they be made to pay? I believe the answer here must be "yes" on all counts.

First, as to the physical part. I believe the necessary power systems can be built. Our generation, transmission and distribution facilities can all be quadrupled in the next two decades. Further, I believe that our progress technologically will make it possible to do this job on a sound economic basis so that the power industry will be able to maintain its record of reducing costs notwithstanding the rising cost trends for fuel, equipment and labor. The industry, in other words, will be able to keep its economic foundation sound enough so that cost of service will not become a barrier to continued expansion.

One difficulty does loom as an item that needs to be a subject of serious concern and of particular interest to your profession. The problem is created by government-owned power generating facilities. In 1932 these represented just over 6 per cent of the total electric supply of the country; by the end of 1952 they had reached a figure of 20 per cent; and are now above that. This increase has largely resulted from the ambitious program which started some 20 years ago for the conservation and development of the natural resources of our rivers. In carrying out this program, however, many projects unrelated to the needs of conservation have also been undertaken, and it is by no means certain that this process has run its course.

Up to now the private power industry has, in general, managed to expand as needed and to thrive notwithstanding government activities. But I do not believe the trend of constant enlargement of government operations can continue another two decades without hurting private operations. And if we are hurt our capacity to fulfill the country's future requirements will be impaired. It is not a simple matter of saying if the private companies were to be prevented from doing the job adequately, then the government will do it. I am confident that the quadrupling of power resources in the next two decades can be accomplished because today we have vast resources of organization, know-how, reliability, efficiency and investor confidence to draw upon. These resources exist predominantly in our private power industry. If these assets are impaired or destroyed by unfairly competitive government operations, we cannot be so confident that the country's future needs will be adequately taken care of.

I am not going to attempt on this occasion to argue the pros and cons of private versus public power. I do want to express what I believe to be the view of most of us in the United States, a view perfectly formulated by Abraham Lincoln speaking 100 years ago:

> "The legitimate object of government is to do for a community of people whatever they need to have

> done, but cannot do at all, or cannot so well do, for themselves, in their separate and individual capacities. In all that the people can individually do as well for themselves, government ought not to interfere."

But it is not to general views above government, its proper functions and its dangers that I wish to draw your attention. As people concerned with figures and economics, I believe that you ought to give thought to one important aspect of government power that you are uniquely equipped to handle. Government power is subsidized power and the most common form of subsidy is the tax route. This is a subject of crucial importance. It has never yet been adequately explored and presented or clearly understood.

About a year ago, a number of people, among them the distinguished ex-governor of the State of New York, claimed that public power operation is more desirable because it can be carried out without paying taxes. I think you all know that such tax savings do not exist. So-called savings, by going to a government setup, merely result in the general taxpayers, rather than those benefiting from the project, paying through additional taxes the subsidy enjoyed by tax-free operations. And a general application of the idea of tax-free operations would, obviously, result in complete disorganization of all government.

Let me get to a specific case illustrating the type of closer analysis which I think the subject requires.

In a typical private power system you may assume that its capital structure consists of 50 per cent debt and 50 per cent equity capital, and you may also assume that the necessary annual return on this capital is 6 per cent. If the interest rate is 3 per cent on the debt capital, 1.5 per cent will be earned by the debt portion and 4.5 per cent by the equity capital portion. Where we also have a 50 per cent income tax rate, 4.5 per cent has to be earned additionally as the necessary federal income tax component if the equity component of 4.5 per cent is to be available. Assume that the state and local taxes are reasonably modest and amount to 2 per cent, but that a federally owned power project would not pay more than ½ per cent—this, too, is reasonably close to the facts—there is then an additional 1.5 per cent tax component on investment in the privately owned facilities which does not exist in the case of the government owned project. The total of the two tax components is another 6 per cent, that is, 6 per cent in addition to the 6 per cent annual return required to support the capital investment.

Now take a very simple system consisting of a generating plant and a high voltage transmission network and assume that the cost of capacity is $140 per kilowatt for power plant and $60 per kilowatt for transmission and related facilities, or a total investment of $200 per kilowatt. It can readily be seen that 6 per cent tax burden on $200 of investment per kilowatt represents a charge of $12 per year. If this kilowatt is to operate at a very high load factor, that is, at 8,000 hours per year, this represents a difference in cost due to taxes of 1.5 mills per kilowatt-hour.

Now 1.5 mills may not sound like a great deal of money, but the difference in a rate for electrochemical or electrometallurgical operation of 1.5 mills (that is the difference in rate between 5.5 mills per kilowatt-hour and 4 mills per kilowatt-hour), can make a difference of as much as $750,000 a year in the power bill in a modest industrial installation. For such an operation the differential is likely to be a decisive factor in influencing the location of the industrial plant at a site where it can obtain the subsidized power. The net effect of this condition is like that of an irresistible magnet to draw industry requiring heavy quantities of electric energy from other locations that but for taxes are equally as well situated and might perhaps otherwise be even more favorably situated.

This same phenomenon tends also to extend the area of operation of the subsidized project. Other areas subject to such competitive forces are tempted to ask the governmental subsidized operation to extend its sphere of activity. Thus unless there is specific legislative delimitation of the sphere of activity of a subsidized operation there can be no practical limit to such area unless those responsible in government decide to call a halt. But it is not natural to expect those administering a project to delimit themselves, and perhaps they may not legally do it even if they wished to.

The foregoing analysis shows what happens between a government owned utility and a private utility in supplying a heavy power-consuming load. Analysis becomes more difficult when the objects of comparison are large government versus large privately owned systems which include generation, transmission, distribution and multitudinous customers.

On the one hand, we have utilities operated by municipalities, states, cooperatives and the federal government. Under our general tax structure these agencies enjoy either a complete or a substantial tax immunity.

On the other hand, there are the private systems which are fully taxed. This is merely another way of saying that consumers who buy from private systems pay a tax which consumers attached to government systems are not asked to pay. For in any business activity an enterprise which is taxed is in reality a tax collection agency. This is certainly true in the power industry. A company must realize certain minimum earnings after taxes to be able to attract new capital to improve and expand its business. And as a regulated enterprise—and it is reasonable to assume that the utility is never earning any substantial percentage above the required, the allowable fair rate—it is obvious that the original tax and any increase in it must of necessity be obtained from the consumer.

So, in the case of the private power industry we serve customers whose electric bills of necessity contain a substantial tax component. The customers of government systems pay no such component, or at most, one that is only a fraction as large. Your profession, which is so well equipped for the task, could perform a valuable public service by seeing to it that the full consequences of this situation are explored and understood.

Our inherent distrust of encroachments of government into the economic field and the conviction that whatever the people can individually do for themselves the government ought not to interfere in, are re-enforced by the experience of particular significance to accountants and students of accounting: that government power is subsidized power, and cannot, therefore, be in the public interest. The hidden subsidies may be difficult to detect but they are not impossible to detect if approached on the accounting level. I believe that the most common locus for subsidy is the tax area, and that it is here that subsidies need to be pinpointed and measured in order to reveal the serious dangers in public power.

Since the foundation of our political system is that the people can be trusted to choose the right course whenever the acts needed for judgment are fully disclosed, there is every reason to believe that in this case too the proper action to delimit and stabilize our public power operations can be brought about, and the development of the great pools of power that the country will be called upon to use in the two decades ahead will continue without interruption and as fast as the country's growing population and increasing productivity will need them. In this, you the accoutants, by bringing to light and analyzing the hidden facts can play a significant part.

PRESENTATION OF DISTINGUISHED ACCOUNTANT TO THE ACCOUNTING HALL OF FAME

DEAN WALTER C. WEIDLER: Since 1950 there have been 15 accountants honored by election to the Accounting Hall of Fame. This year one additional name is being added to this distinguished list. I am pleased to present Vice President Jacob B. Taylor, who will now confer the honor, and Mr. George D. Bailey, Chairman of the Board of Nominations who will present the candidate. Mr. Taylor and Mr. Bailey.

MR. BAILEY: It is my very great honor as Chairman of the Board of Nominations to present the name of a distinguished accountant to be installed in the Accounting Hall of Fame of The Ohio State University. The Board of Nominations of The Ohio State University Accounting Hall of Fame presents Percival Flack Brundage.

Upon graduating from Harvard University he entered the field of public accounting and became a member of the staff of Price Waterhouse and Company in 1916. He became a partner in this firm in 1930 and served as senior partner from 1944 to 1954. A certified public accountant of several states, he has served as President of the Massachusetts Society of Certified Public Accountants and Vice President of the New York Society.

As a member of the American Institute of Accountants since 1921, he has been very active in its efforts to develop high professional standards. He has been chairman of the committees on Relations with the Bar and Cooperation with the Bureau of Economic Research. Moreover, he has been a member of Council, the Executive Committee, the Board of Examiners, the Trial Board, and the committees on Personnel, Nominations, Publications, Budget and Finance, Auditing Procedure, and Cooperation with the Stock Exchange. Finally, he was honored with the Presidency of the Institute in 1948.

In addition to his devoted service to the profession of accounting he has been active in other fields. As an economist he is a past president of the National Bureau of Economic Research and also of the Society of Business Advisory Professions. He was Chairman of a study group on business income sponsored by the American Institute and the Rockefeller Foundation which published a report in 1952 entitled "Changing Concepts of Business Income."

In the religious field he has served as Director of the American Unitarian Association for six years. He is now President of the International Association for Liberal Christianity and Religious Freedom. During World War II he was Director of the American Christian Committee for Refugees. He has been Chairman of Refugee Relief Trustees and for 10 years served as Director of the Unitarian Service Committee.

In 1954, he accepted a call to the position of Deputy Director of the Budget. His talents and knowledge gained through years of experience eminently qualify him for this responsibility. This is a distinct honor to the accounting profession which he will represent with dignity and high ability.

For his leadership through many years in promoting higher standards of professional service and ethical conduct, for his contributions to the life of his community and of his Country, the Board of Nominations of The Ohio State University Accounting Hall of Fame is proud to present Percival Flack Brundage.

MR. TAYLOR: Mr. Brundage, for your outstanding contribution in the development of the profession of accounting, upon the recommendation of the Board of Nominations, by the authority of this University, I have the honor to inform you that your name has been placed in The Ohio State University Accounting Hall of Fame. In testimony thereof, I present you with this appropriate certificate, duly signed and with the seal of the University attached. To the felicitations of the University, I add my personal felicitations.

(Mr. Brundage made a brief statement of appreciation of the honor which he had just received.)

FIFTH SESSION

FRIDAY, MAY 20, 1955—12:30 P. M.
Ohio Union—West Ballroom

Presiding:

HARRY J. TRAINOR, *Assistant Commissioner of Internal Revenue in charge of Inspections, Washington, D. C.; President, Federal Government Accountants Association*

Paper: "Changes and Developments in Income Tax Accounting"

T. T. SHAW, *Partner, Arthur Young & Company, New York, New York*

Paper: "Some Accounting Provisions of the Internal Revenue Code of 1954"

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CHANGES AND DEVELOPMENTS IN INCOME TAX ACCOUNTING

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It is just about 20 years ago that I worked through a volume of Taylor and Miller's practical problems in preparing for my CPA examination. I had never heard of Taylor and Miller before that time, but after working through all of the problems I concluded they must be good because I could not find a single error in their volume of solutions. Today, twenty years later, I still feel that Taylor and Miller must be good because there is so much evidence of it around here. The Ohio State University is a fountainhead of accounting knowledge—a place where you are made to recognize that accounting is a profession just like law and medicine. It is a compliment to be invited to participate in a program such as this. I have also been assigned an interesting subject. It is an accounting subject, which is appropriate. It deals with changes and developments in tax accounting, and this too is appropriate. There have been more changes and developments in tax accounting during the past year than in any earlier year back to the inception of the income tax law in 1913. There has even been an about-face on some changes.

Numerous areas of tax accounting have been affected by these recent changes. John Costelloe and I have divided up these areas between us. I shall have something to say about prepaid income, reserves for expenses, changes of accounting method, hybrid accounting, spreading of income, refunded income and the new depreciation methods. John Costelloe will talk to you about accounting for research and experimental costs, accounting for real property taxes, installment sales, the 52–53 week taxable year and about accounting for carry-overs to successor corporations in liquidations and reorganizations.

We will then try to leave some time at the end for questions.

Changes of Accounting Method

The new Revenue Code contains a provision dealing with the extent to which adjustments will be required upon a change in accounting method. The adjustments are those necessary to avoid duplication or omission of items of income or deduction on the change-over.

Under prior law as interpreted by the courts, the rule seems to have been that all adjustments required to prevent tax avoidance had to be made if the taxpayer's change were voluntary, but not if it were involuntary. In other words, if the Commissioner forced you into making a change, he could not make you pick up items which you omitted in prior years under the old method; but if you asked for permission to make the change, the Commissioner could make you pick up the items omitted in prior years as a condition to allowing you to make the change.

The new Revenue Code requires all adjustments either way (i.e., to avoid duplication or to avoid omission) to be made in all cases, except where the adjustment relates to a taxable year prior to 1954.

If the adjustment applies to a year prior to 1954 one gets the impression from reading the law and the committee reports that you just forget about it and do nothing. For example, if a calendar year company changed from the cash to the accrual method at the first of 1954 and had $10,000 of opening 1954 inventory which had been deducted as a cost under the cash method in 1953, the law seems to indicate that you can reduce 1954 income by setting up this opening inventory and that you do not have to pay any additional tax for prior years when you erroneously got the inventory as a deduction. It seems to me, however, that under these circumstances the Revenue Service can require a taxpayer to adjust all open prior years where inventories existed and impose additional tax through the inventories into account. It is not clear, however, whether the Commissioner could properly maintain that the taxpayer had taken an inconsistent position in setting up the inventory at the beginning of 1954 when he had not set up a corresponding amount of inventory at the close of 1953. If the taxpayer has, in fact, taken an inconsistent position, the Commissioner could apparently adjust even prior statute-barred years as well as prior years which are not statute-barred.

The example I have just cited refers to a case where a taxpayer was erroneously using the cash method in 1953. Under these circumstances, it seems to me he should not need to obtain the Commissioner's permission to change over to the accrual method in 1954. You should not have to obtain permission to go from an erroneous method on to a correct method. However, I am informed that it is the position of the Revenue Service that even where you are using an erroneous method, for example the cash method when you should be on the accrual, you still require the Commissioner's permission to make the change. I had been under the impression until recently that you did not need the Commissioner's permission to correct errors, including erroneous accounting methods, but my information now is that you do need such permission. Perhaps the reason is that an "erroneous" method may acquire a stature of correctness where long and consistently used. In any case, you cannot make changes which will distort income without permission.

There are cases where a taxpayer may have been properly using, for example, the cash method in 1953 but wishes to change to the accrual method for 1954 or 1955. A law firm or an accounting firm with unbilled or uncollected fees would be a good illustration. The law seems to indicate that even in cases like this adjustments attributable to years prior to 1954 do not have to be made. For example, assume a law firm on a calendar year basis had $100,000 of uncollected fees outstanding at the close of 1953 and a similar amount outstanding at the close of 1954, and that it wished to change from the cash to the accrual method of reporting in 1955 . Since the firm was properly on the cash method in 1954, it would have to obtain the Commissioner's permission to change over to the accrual method for 1955.

One of the tax services indicates that in an actual case recently the Commissioner required that the pre-1954 unreported income be picked up as a condition to permitting the change-over. However, I am informed that this statement in the tax service is incorrect, and that the Commissioner has not yet issued any rulings or taken any position on the point under the 1954 Revenue Code. Whether the Commissioner has authority to require a taxpayer to pick up unreported pre-1954 income upon a change-over is doubtful. But it seems almost certain that the Commissioner will take this position. Whatever the law says, it would scarcely make sense for the law firm in the illustration I have just cited to escape tax on the $100,000 of uncollected fees outstanding at the close of 1953 just because it got the bright idea of changing over from the cash to the accrual method. It seems to me that if the Commissioner does not at present have authority to require a taxpayer to pick up the unreported income on the change-over, in a situation such as this, the law should be amended to give him that authority.

It will be seen, therefore, that two different situations can exist with respect to prior-year adjustment upon a change of accounting method. If you are changing from a wrong method to a right method it seems to me you should not need the Commissioner's permission to make the change, but the Commissioner says you do need it. If, on the other hand, you are changing from one correct method to another correct method, you do need the Commissioner's permission, but can he make you pick up pre-1954 adjustments as a condition for the change-over? The law seems to indicate that he cannot require this, but my guess is that the Commissioner will try to insist on it.

I have so far talked about only the problems that may arise out of pre-1954 adjustments. As to years not affected by these adjustments the rules under the new law are simple. Voluntary and involuntary changes will be treated the same from here on. To mitigate the hardship that might result from bunching the adjustment in the year of change-over, the new Revenue Code, where the income adjustment exceeds $3,000, permits the adjustment to be spread equally over the year of change and the preceding two years, or, if the taxpayer can spread the adjustment back on an accurate basis, over the years which are in effect being corrected. In either event, the resulting tax increase is tax for the change-over year, not additional tax for the prior years to which the income has been pushed back.

The two alternative methods of making the adjustment may be described more precisely as follows:

> Under the first alternative, the taxpayer may compute the additional tax occasioned by the adjustment as though one-third of the adjustment were included in taxable income for the year of the change and one-third were included in taxable income for each of the two preceding years.
>
> Under the second alternative, the taxpayer may establish what his taxable income would have been if correctly computed under the new method of accounting for the prior years affected. The additional tax occasioned by the adjustment would be limited to the additional tax computed on this basis.

The additional tax computed under either of these alternatives could not, of course, exceed the additional tax which would be payable if the amount of the adjustment were included in the taxable year and not spread back at all.

These two alternative methods of applying back the adjustment differ between each other in one important respect. If you use the first alternative and spread back the adjustment pro-rata over three years, you disregard any effect it may have on net operating loss carry-backs or carry-overs or on capital loss carry-overs. These carry-backs and carry-overs are left unchanged. In other words you get a break through not having to shrink or eliminate these loss carry-backs and carry-overs despite the spread back.

Let us assume a company had a net operating loss of $100,000 in 1954, which it carried back and recovered tax on in 1952 and/or 1953. Assume further that in 1956, under the three year rule, it spreads back $100,000 of income to 1954, thus wiping out the $100,000 net operating loss for that year but not creating any tax. Despite this, the 1954 net operating loss still stands for carry-back purposes and the tax recovered through carrying back the loss to 1952 and 1953 can be retained by the taxpayer.

This is not so under the second alternative. If you spread back the adjustment to the year or years to which it properly applies, you have to take into consideration any effect the spread back may have on net operating loss carry-backs and carry-overs and on capital loss carry-overs.

This difference with respect to losses between the two alternative methods of applying the spread back is brought out in section 481(b)(3)(A) of the new Code. The difference in treatment seems to have been deliberate and not an oversight.

Hybrid Accounting Methods

Under the law in prior years some taxpayers used accounting methods which did not follow strictly either the cash or the accrual method. On occasion these hybrid methods were successfully challenged by the Revenue Service, but for the most part they were accepted provided they were consistently followed and did not result in serious distortions. The new Revenue Code specifically sanctions the use of hybrid methods, but it is left to the regulations to say just how "hybrid" a method may be.

The Senate Committee Report on the new Revenue Code gives as an example of the hybrid method the case of a small retail store where the accrual method could be used for such items as purchases and sales of goods, while the cash method would be permissible for such items as rent, interest, insurance and salaries. Any hybrid method is, of course, subject to the general requirement that it clearly reflects income.

It would seem that a hybrid system would be of interest primarily to the smaller taxpayer who keeps his own books. Certainly in the case of larger businesses whose accounts are certified by independent accountants, there would be a question as to the propriety of a hybrid accounting method which would treat any substantial items inconsistently, some on the cash method and others on the accrual. It is known that some large accrual method taxpayers consistently treat state and local taxes on a cash basis purely as a matter of convenience, since the effort involved in making numerous accruals seems futile where the effect on income is inconsequential. But in the case of other items of expense, there can be wide distortions if the cash method is employed. Accordingly, I believe that the adoption of a truly hybrid system, such as suggested by the Senate Committee Report, will not be widespread, and will be confined to small taxpayers.

Refunded Income

A taxpayer who receives income under a claim of right must report it, even though he may have to refund it in a later year. The refund would give rise to a deduction in the later year. This rule was laid down by the Supreme Court in 1932 in the North American Oil Consolidated case (286 U. S. 417).

This rule is continued in the new law, with a modification, however, where the amount of income which has to be refunded amounts to more than $3,000. Where more than $3,000 of the income has to be refunded, the tax in the year of refund (not the earlier year in which the income was reported), is reduced by the higher of (1) the amount of tax attributable to giving effect to the deduction in the year of refund, or (2) the amount by which the tax of the earlier year has been overpaid. In some cases this reduction can reduce the current year's tax to below zero. In such a case, the reduction below zero is treated as an overpayment for the current year which will be refunded on proper demand.

These new rules with respect to refunded income were enacted primarily for the benefit of public utilities who sometimes receive income from temporary rate increases in one year, part or all of which has to be refunded in a subsequent year after final action in the rate case by the regulatory body. However, the benefits of the section are available to all taxpayers who qualify. For example, the new rule would apply in a case where a stockholder is held liable for debts of a liquidated corporation in a year subsequent to the liquidation and after he has reported a capital gain on the liquidation. Under the Supreme Court decision in the Arrowsmith case (344 U. S. 6), payment of the corporation's debts would result in capital loss to the stockholder in the year he pays such debts. This capital loss might do him little good because of the restrictions on capital loss deductions. Under the new rule, instead of taking a capital loss in the year of payment of the corporation's debts, the taxpayer can, if it pays him better, reduce his tax in the year of payment to the extent he paid an excessive amount of capital gain tax in the earlier year when the corporation was liquidated.

Spreading Back Income

Under the law in prior years, spreading back of income was allowed an individual who received or accrued in one year at least 80 per cent of total compensation for personal services covering a period of 36 months or more from the beginning to the completion of the services. The new law continues this relief provision for preventing bunching of income, but with some modifications.

Under this procedure, the prior years' returns are not disturbed. Recomputations are made as to prior years, but the resulting figures are applied as adjustments to the taxable year, not to the earlier years.

While the new law retains the 80 per cent requirement, it changes the provision to allow relief for compensation from an employment (instead of compensation for personal services) covering a period of 36 months or more from the beginning to the completion of the employment.

This change from compensation for personal services to compensation for an employment is designed to allow spread-back relief only for compensation related to a particular project on which the taxpayer worked (such as a particular law case), and not to a set of unrelated services which the taxpayer may have performed for the same person.

This change is designed to remove several problems arising under the old law in applying the two basic tests for relief. These tests are, of course (1) that the taxpayer's services encompass a period of 36 months or more, and (2) that at least 80 per cent or more of the total compensation for the services be received or accrued in one taxable year.

These rules produced two tendencies on the part of the taxpayers in the past. Taxpayers tried to combine various sets of services in order to meet the 36-month requirement and to separate various sets of services to meet the 80 per cent of total compensation requirement.

The new law does two things. First, by narrowing the definition of services to those performed on a particular project, a taxpayer is barred from adding together periods of work on several different projects (though for the same person), where all together they total more than the required 36 months but where each individually is less than 36 months. It will also bar the Treasury from adding together compensation received from various projects in an attempt to show that the amount received by a taxpayer in one year for one project is less than 80 per cent of the total compensation for that project.

With respect to partnership income, under prior law a partner could spread back his share of income from long-term services rendered by the partnership to years before he had any connection with the firm. The new law prevents this by blocking any spread-back to years before the partner was either an employee or a partner. A partner can tack on those periods in which he was employed by the firm to the actual time in which he was a partner.

It is interesting to note that a partner can still qualify for the spread-back even though he never actually worked on the job, either as a partner or employee, provided he was in the firm when the work was done.

The new law seems to require that for the required period, the employee or partner be a member of the partnership which actually receives or accrues the compensation. This could bar relief to a member of a partnership which receives fees for work done in whole or in part by a predecessor firm, even though he was a member of both firms and his combined period of membership in the two firms extended over the entire job.

Tax relief through spread-back of income from artistic works and from inventions has been liberalized by the new law in two respects.

1. The period of work has been shortened. The 1939 Code denied spread-back relief unless the taxpayer's work on the artistic project or invention covered a period of 36 months or more. The new law cuts down this minimum period to 24 months.

2. The maximum period for spread-back of invention income has been extended. Under the old law, the maximum period over which income from an invention could be spread back was 36 months preceding the end of the year in which the income was received. The new law extends this maximum period to 60 months in the case of inventions. However, the maximum spread-back period for income from artistic works (as distinct from invention income) remains 36 months preceding the close of the year of receipt.

The 1939 Code allowed income splitting on spread-back income received or accrued in a joint return year, even where income was spread back to years before 1948 when income splitting was not allowed. Under the new law, in recomputing tax for a pre-1948 year under any of the spread-back provisions, income splitting is not allowed.

Prepaid Income

The need for a provision in the law which would permit the deferring of prepaid income goes back to 1932 when the United States Supreme Court, in the North American Oil Consolidated case (286 U. S. 417) ruled that where a taxpayer receives income under a claim of right and without restriction as to its disposition, it must be reported for tax purposes.

The Revenue Service has interpreted this to mean, that if, for instance, a landlord receives five years rent in advance under a lease he must report it immediately, even where he uses the accrual method. The fact that the landlord must maintain his building and suffer depreciation and other costs during the five year period is considered to be beside the point. The income must be reported immediately while the costs and expenses over the five year period will be allowed as deductions only when incurred.

This rule does not make sense accountingwise because it taxes gross income, and taxes it prematurely, before it is earned.

The Revenue Service in New York is trying to maintain in one instance, that even though a taxpayer has not yet received the income for services to be rendered under a service contract, but has merely set up an account receivable with the offsetting credit to deferred income, it has nevertheless realized income which must be reported and taxed at 52 per cent. In other words, the Revenue Service is trying to maintain that the claim of right rule applies not only to actual receipts, but extends to accounts receivable for services to be rendered in the future.

Accountants could never certify statements reporting income prematurely in this way. They would probably be accused of fraud if they did.

Accountants thought they had made Congress see the light when they got section 452 included in the 1954 Revenue Code. However, in May 1955, we now find that, while Secretary Humphrey, Colin Stam and the Congressional Committees all agree that that section 452, permitting the deferment of prepaid income is right and proper and should be in the law, the changeover to that rule would be too expensive for the Treasury to stand, and so section 452 must be repealed retroactively.

Retroactive legislation is undesirable at any time. It is doubly bad when it repeals a provision which everyone agrees is necessary and correct.

To complicate the situation, the Revenue Service has for many years been permitting certain industries to defer prepaid income because that made sense accountingwise. But when other industries now ask for similar permission, the Revenue Service says it cannot give it.

A recent decision of the 10th Circuit Court (Beacon Publishing Company v. Commissioner) permitted a company to defer prepaid subscription income much the same way as section 452 of the 1954 Code would have permitted it to be deferred.

The 10th Circuit distinguished the facts in this case from the facts in the North American Oil and other Supreme Court cases, stating that the only issue in those Supreme Court cases was whether a mere claim of ownership of the income was sufficient to subject the income to tax, and there was no issue (as there was here) as to when income is taxed where there is no dispute as to ownership. The court disagreed with prior cases which held that the "claim of right" doctrine established a rule for the time when income is taxed.

The Tax Court is apparently unwilling to follow the Beacon decision, because it has rendered a decision to the contrary in a more recent case (Andrews, T. C.). The Revenue Service has not yet decided whether or not it will follow Beacon. However, the Beacon case is a hopeful sign. It indicates that at least one of the circuit courts is beginning to pay attention to commonsense accounting rules. It creates a hope that even without the benefit of section 452 in the law, the courts in general may ultimately come to recognize the accounting principle of reporting income only as it is earned.

Reserves for Estimated Expenses

Most of us have been following closely the proposed repeal of Section 462 of the 1954 Revenue Code. The accounting profession was instrumental in getting this provision into the law. The section is now being repealed retroactively because Secretary Humphrey says this provision would create a revenue loss greater than the Treasury could stand. That is the official reason. I do not think, however, that it is the full reason.

I believe the Treasury feels that this section has been subject to abuse, and that many taxpayers have not been concerned about bringing tax accounting into line with book accounting (which was the reason for the section being in the law), but rather they have been concerned with getting some extra tax deductions. I feel sure that most accounting firms have clients who dreamed up expense reserves they would never even have thought about had it not been for the advantage offered by section 462.

It is unfortunate that responsible members of the accounting profession initially took the position that taxpayers should not be required to place on their books expense reserves they were claiming for tax purposes. How can anyone properly maintain, as the accountants did, that we need a provision in the law to bring tax accounting into line with book accounting, and then, having obtained that provision in the law, object to the requirement in the proposed regulations that the reserves be placed on the books? Responsible people in the Treasury must have felt that the accountants were not sincere in asking for a provision to bring tax accounting into line with book accounting, and that what they really wanted were some extra tax deductions.

Another unfortunate happening was that some of the tax services put out gaudy advertising literature, almost saying that you could make a killing if you adopted the new accounting methods under the 1954 Code, and that their service would show you how to do it. Some of this advertising probably reached Secretary Humphrey.

The principle of section 462 is sound. It would be right and proper for necessary expense reserves standing on the books to be allowed as deductions for tax purposes. What was not proper was that many taxpayers wanted to claim every kind of reserve they could think of, but not place these reserves on their books.

We accountants should continue to make efforts to get a provision such as section 462 enacted into law, but we should also recognize that such a provision would be for the purpose of eliminating the differences between tax and book accounting not for the purpose of giving extra tax deductions.

New Depreciation Methods

The 1954 Revenue Code, in Section 167, provides a radical departure from the 1939 Code in the deduction it allows for depreciation of assets acquired new after December 31, 1953. By this time it should hardly be necessary to describe the mechanics of computation of the two new specific methods: the double-declining balance method, and the sum-of-the-years digits method, but certain basic principles applicable to the new methods require emphasis. Since final regulations on this section have not yet been issued, what I have to say is based principally on the proposed regulations which were released some time ago.

Which assets qualify: The new methods may be applied only to tangible assets (including leasehold improvements) with a life of three years or more which were acquired new after December 31, 1953. If construction were started in 1953 and completed in 1954, the new methods can be applied only to costs incurred in 1954 unless the contractor held title in 1953, and it was not acquired by the taxpayer until 1954. Similarly, the new methods can be applied to any capitalized reconditioning costs of capital assets if such costs were incurred after 1953.

Manner of making election: No formal election to use the new methods is necessary other than computing depreciation under the elected method in the return. They may be used in any taxable year ending after 1953. Different methods may be chosen for different asset items or classes of assets within a given year and a new election may also be made for each year's additions. For example, trucks bought in 1954 may be depreciated on the declining-balance method, while trucks bought in 1955 may be depreciated on the straight-line or sum-of-the-year's digits method. The only restriction is that once a method is chosen for a particular year's acquisition, a particular class of assets, or for specific assets, it cannot be changed as to these acquisitions without the Commissioner's consent, except that a change from the declining-balance to the straight-line method may be made at any time. Amended returns for years ended after 1953 can be filed any time before January 1, 1956 to adopt the new methods (but not to revoke an election once made). It is not necessary that the regular books of account reflect the new methods so long as the taxpayer maintains adequate subsidiary records which permit reconciliation between book and tax basis depreciation.

Questions unanswered by proposed regulations: As might be expected with most new tax laws, the Commissioner's regulations leave many problems unsolved. For example, the proposed regulations are silent on how the sum-of-the-years digits method is to be applied on a composite account nor is it clear when losses on retirements can be claimed where group or composite accounts are used. Little light is shed on possible methods which might be elected under section 167(b)(4), the provision which states that any other consistent method may be adopted on new assets provided it does not give an aggregate depreciation write-off any larger than under the double declining-balance method at the end of the first two-thirds of useful life.

Advantages of new methods: It would seem that one or the other of the new methods (or possibly a combination of them) will be adopted by most taxpayers. It seems to me you have everything to gain and nothing to lose by adopting one or the other of these new methods. Although it is true that the additional depreciation taken during the first half of an asset's life necessarily reduces the allowances during the last half of its life, the benefit of increased annual depreciation allowances will continue beyond the life of present assets so long as new additions are made at a fairly uniform rate. Furthermore, these new depreciation methods have some logic to them in that the income producing utility of an asset is frequently greater in its early years. A taxpayer who does not use the new methods will, if they are generally adopted, bear a disproportionate share of the tax burden through failure to adopt the methods.

Although a taxpayer may decide that one or other of the accelerated methods should be adopted, it is not easy to choose between the double-declining-balance and sum-of-the-years-digits methods. Double-declining is probably easier to apply, particularly to classified or group accounts. One objection raised to the double-declining method is that it leaves an unrecovered balance at the end of the useful life. This objection has to be considered in relation to the problem of salvage value and, particularly, the possible attitude of the Internal Revenue Service. Since a switch can be made at any time from double-declining-balance to straight-line depreciation the undepreciated balance can, of course, be taken care of, but at the time of the switch, recognition of salvage value will probably be required by the Revenue Service. Although regulations have always provided that an asset is not to be depreciated below its salvage value, the Revenue Service has heretofore not been strict in enforcing the provision, recognizing the difficulty of making a reasonable estimate of salvage value years in advance.

A recent Revenue Service ruling (I.R. Mimeograph 55–30, P-H Para. 76,305) indicates that where taxpayers have entered into prior agreements with the Revenue Service with rates and methods of depreciation, such agreements will not be applicable as to those assets on which taxpayers desire to compute depreciation under any of the new accelerated methods. Taxpayers who have not heretofore been challenged on the use of straight-line rates which in all likelihood are too high, may well expect an attempt by the Revenue Service to revise these rates downward where the new depreciation methods are being availed of. It is significant that in a recent special notice (I.R.B. 1955–8, 53) concerning depreciation policy and Bulletin "F," the Revenue Service warns that many of the useful lives in Bulletin "F" are outmoded and that taxpayers should be prepared to substantiate the periods used. A revised Bulletin "F" based on a comprehensive study of the subject is currently being prepared so that taxpayers may have a more up-to-date guide.

It should be remembered that nothing in the new law in any way restricts or reduces depreciation allowances which were available under the 1939 Code. Thus, taxpayers may still use the declining-balance method (limited to 150 per cent of the straight-line rate) which was permissible under the old Code even on assets which were purchased used. Extractive industries can continue to use the unit-of-production method regardless of how much depreciation is claimed in any year. It will require analysis of each major fixed asset addition before a proper determination of depreciation method can be made.

Questions of Interest

I have listed a number of questions of interest to taxpayers in relation to the new depreciation methods, and also the best information I have on these questions.

1. When will the final depreciation regulations appear?

These now have top priority in the Treasury, and barring anything unforeseen should be out within a month.

2. What is the possibility of using the sum-of-the-years-digits method with group accounts?

As you know, the proposed regulations were silent on this point. The main difficulty is in determining how to handle the unrecovered cost of retirements prior to the average life of the group. Some taxpayers claim this should be allowed as a loss on retirement. The Treasury holds that this would be contrary to the theory of average lives and group accounts. Therefore, the Treasury will not allow unrecovered cost of retirements prior to the average life of the group. There are a number of formulas which will accomplish a satisfactory spreading of this cost over the actual remaining life of the remaining assets in the group but all of them are considered too complicated for general use. The regulations will probably say that any method can be used, with approval, if it spreads the cost over the total actual life of the group—similar to the way straight-line group accounts are supposed to work. The regulations will also probably contain some examples of acceptable methods. In any event, it is safe to say that something will be worked out to make sum-of-the-years-digits method practicable in the case of group accounts.

3. Is there likely to be more attention given to the requirement that residual value be taken into account when depreciation is calculated?

Yes, the Treasury is concerned about the utter disregard of residual value in the past. Also, in view of the liberalization of depreciation it seems one of the few things left for revenue agents to argue about in relation to depreciation. The Treasury is alive to a gimmick which permits the owner of a car to use it for practically no cost. He must, of course, use the car in business; then he depreciates it under one of the new methods over let us say, a 3-year life. He can get 66⅔ per cent in the first year (double declining balance rate). At the end of the first year he sells the car, gets capital gain treatment, and net of taxes the use of the car has cost him practically nothing. He can, of course, continue to use the gimmick year after year. Look for a rule which says that salvage value must be realistic, not just junk value, and also that useful lives must be realistic. This example of the sale of the car demonstrates how foolish the rule is which permits capital gain treatment on sale of assets after depreciation has been allowed as an ordinary deduction. Old Section 117(j), which is now Section 1231, is just a one-way street in favor of taxpayers, and the Treasury knows it. However, any attempt to repeal this section would probably meet political opposition.

4. Does salvage have to be taken into account when using the double-declining balance method?

Not in computing the rate, but when you have reduced unrecovered cost to a realistic salvage you have to stop taking depreciation. This is true for any method. There are a number of people putting out incorrect information on this point, encouraging taxpayers to use this method, then depreciate below salvage and take capital gain. I understand this will be prohibited.

> 5. How much consistency is required, e.g., if sum-of-the-years-digits is used for assets bought this year, must it be used for similar assets bought next year, or for other assets bought this year?

The only consistency required is in respect of each individual asset itself. Once you make an election for an asset the same method must be used consistently for that asset except that you can always change from double-declining-balance to straight-line depreciation. Each asset is subject to a separate election if you so desire. The only requirement is that you account for different methods separately, i.e., if you use different methods you have to put the assets in separate accounts and keep separate reserves. You cannot mix sum-of-the-years-digits and declining-balance assets in the same account.

> 6. Can assets with less than a three-year life be put into group accounts under the new depreciation methods, if the average life of the group is more than three years?

No, the law says the new methods can be used only as assets with a life of three years or more, and the Treasury is going to stick to this even in groups.

> 7. When using the double declining-balance method and taking advantage of the automatic switch to the straight-line, will a taxpayer be able to depreciate the balance of unrecovered cost over the remainder of the original estimated life?

No, a new estimate of remaining useful life must be made and the balance (less salvage) must be depreciated over the period.

> 8. What does "original use" mean? This term is used in Section 167. If an old asset is converted to a new use is it eligible for the new methods?

No, original use means the first use to which an asset is put. Changing its function will not make it new.

> 9. The cut-off date for the new depreciation methods (December 31, 1953), has raised a number of questions, some of which have not yet been answered. For example:
> (a) If materials in inventory at the end of 1953 are used in construction in 1954, are they eligible for the new methods?
> (b) If a piece of equipment is bought and delivered in 1953 but not installed so it can be used until 1954, is it eligible?
> (c) Assume assets are being constructed for a taxpayer to his specifications, started in 1953, completed in 1954 and title passes in 1954. Is total cost eligible, or only the portion attributable to 1954 costs?

These questions have not yet been resolved, and the answers are consequently not yet available.

SOME ACCOUNTING PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954

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Of all that lively land we call Midwest, Ohio is the high spot. Your farms, your factories, your cities and your universities have wonderful vigor, and there seems hardly any limit to what the mind can conceive and the hand achieve.

Where you find activity you find accountants. And so we have this happy meeting of town and gown, and of industry and academy, to consider old problems of accountancy in light of the new tax law.

It used to be said that there were more accountants than farmers. The new Internal Revenue Code may further that imbalance; but it has made farmers out of some lawyers and even some accountants.

The new Code contains some provisions on accounting that even a lawyer like myself should easily understand. It also has some that lawyers have been slow to understand—consider the adventures of Section 462, of which Tom Shaw has spoken. And it has some that nobody may ever fully understand without more help than is now at hand.

At the light end of the scale we have statutory recognition of a 52-week accounting period with an occasional 53-week period thrown in to keep the year-end from wandering all over the calendar.

At the heavy end of the scale we have new provisions for handling tax attributes in cases of some kinds of changes in corporate life or structure.

So I shall speak of some provisions that pall and some that appall. I will try to be as informative as I can without losing informality, and to account as well as I can for the time you have so generously if unwisely allotted to one who is not an accountant.

52 or 53-Week Year Accounting Periods

In some lines of business it had been customary to close the year's books on a particular day of the week rather than on the last day of the month. Section 441(f) of the new Code provides that this is permissible for tax purposes if done for book purposes. The grant of permission required some special rules for effective dates, and for transitional problems which may arise in adopting the new method.

These provisions are hardly of great importance in themselves. But they do illustrate an important problem faced by the new Code's draftsmen: how far should the tax laws accommodate to business practices? By and large, the answer has been in favor of accommodation. That usually necessitates more law, some of it complex. But it is not a simple world we live in, and it is hard to quarrel with answers such as the one arrived at here. It makes unneccessary, adjustments to book accounting which are for all practical purposes of no substantive consequence to anybody, except the poor fellow who has to work them up for an employer or client who can hardly be expected to be enthusiastic about the job.

Other provisions intended to make tax law accommodate to business practices have had significant tax consequences—most spectacularly, Section 462. That Section and its distant cousin, Section 452, have been discussed by Tom Shaw, and I will not again tread the ground he has so thoroughly covered.

Installment Accounting

When I was a young man it was creditable to stay out of debt. Nowadays, one does not go in debt but instead uses his credit; and there is much installment selling and accounting.

For many years, the revenue laws have recognized installment accounting for tax purposes, and have provided an elective method of accounting, whereby the gross profit on installment sales might be taken into taxable income only as collections are made.

Under old law, an accrual basis taxpayer changing to the installment method of accounting might incur double tax. The taxpayer was required to include in taxable income, amounts of gross profit actually received during years for which the installment method had been elected, even though they had been included in taxable income of a prior year.

Section 453(c) of the new Code considerably mitigates that very harsh feature of the old law.

It provides that the tax for the year of actual receipt shall be reduced by the lesser of two different amounts. The first is the portion of the tax for the year the gross profit was first reported which is attributable to that gross profit. The second is the corresponding portion of the tax of the later year of actual receipt.

These portions are in effect determined by multiplying the total tax of the particular year by a fraction, having as its numerator the gross profit and as its denominator the gross income of that year.

By giving the taxpayer only the benefit of the smaller of the two amounts of tax so determined, the new Code will usually require the taxpayer to pay tax at the higher rate applicable to either year, whether the higher rate is the result of a change in rates or of a change in the taxpayer's income which produces a different effective rate.

And since the two amounts are computed with reference to relationships of gross profit and gross income, the new Code does not make allowance for the fact that even where all other factors are equal, the tax in the first year might have been smaller, since the expenses of sale will have been deducted in determining taxable income.

Some of us have thought that any tax cost for a change from the accrual to the installment method is anomalous, particularly in view of the general policy adopted in provisions of Section 481 of the 1954 Code. As you know, that Section provides that other changes in accounting method may be made with no element of double inclusion in income.

Although installment accounting still gets relatively unfavorable treatment, it may be possible in many cases to obtain fairly satisfactory tax results by effecting a taxable disposition of installment items which have already been accrued for tax purposes, before the start of the first year for which the installment method is elected.

The new Code does away with the minor but frequently annoying requirement of an initial payment, which had been read into the old law by administrative action with respect to sales of real property by a dealer or a non-dealer and to casual sales of personal property. The elimination of this requirement in turn raises the interesting question whether a one-payment contract can qualify for installment accounting, and the answer to that question may provide new opportunities for tax planning.

Installment accounting has always been a rather delicate thing, in that many kinds of transfer served to terminate it for tax purposes and accelerate gain or loss. Under the old Code, transmission at death of the owner would have this effect unless bond were posted to cover income tax involved in future installment payments to the recipient. Posting the bond was thus an effective means of exercising an election to continue the installment method. The new Code has made posting of the bond unnecessary, but in so doing apparently has destroyed the elective feature, which had been useful in tax planning.

Installment obligations also come in for special treatment in connection with some kinds of corporate changes, of which I will speak a bit later if my prose and your patience persist so long. In case they do not, I should say that the general picture is that of a live bird caught in a real badminton game.

Real Property Taxes

The usual procedure under the old law was to try to fix the accrual of real property taxes with reference to local law concerning the assessment date, or the time when the tax became a lien on the property, or the time when personal liability for the tax arose, or on some other basis. The new Code, in Section 461(c), gives taxpayers the choice of living with the old law as it applied to them, or of electing the method long favored by accountants: accrual ratably over the fixed period to which the tax relates. It may be difficult in some cases to relate a particular real property tax to a particular period; in a few cases that may be impossible. But by and large, it should not be particularly difficult.

The new Code contains special provisions to cover the period of transition from prior law to the new elective rule, to ensure that the same tax will not be deducted more than once, and also that no otherwise proper reduction shall be lost. It also provides in Section 164(d), for apportionment of real property taxes between buyer and seller.

If the new Code leaves any room for regrets in this area, it is with respect to personal property taxes. Presumably the law on those taxes will be much influenced by the new developments on real property taxes; but one can wish for express statutory treatment of personal property taxes.

Research and Experimental Expenditures

In this budget message of January 21, 1954, President Eisenhower made recommendations on this subject which foreshadowed the provisions of Section 174 of the new Code concerning these expenditures. In his words:

> "I recommend that all companies be given the option to capitalize or to write off currently their expenses arising from research and development work. Our tradition of initiative and rapid technological improvements must not be hampered by adverse tax rules."

Under-Secretary of the Treasury Folsom gave further details in his testimony before the House Ways and Means Committee on the Bill which became the new Code. He said (p. 123):

> "In large companies there is little difficulty involved in writing off the cost of development and research expenses. In small companies there is some uncertainty about it. A concern might buy a patent or have a heavy investment for research in one year. The tendency has been in some cases to make them capitalize that and write it off over a period of years instead of charging it off over a year. Now, we suggest making it optional. A concern can write it off in one year or spread it over a period of years."

In a speech before the American Management Association last August, after enactment of the new Code, the Under-Secretary said:

> "The 1939 Code made no specific provision for the research and experimental expenditures which are so vital to the growth and increasing efficiency of American business. * * * The new Code gives all taxpayers the option to deduct such expenses currently or to capitalize them and write them off over a period of not less than five years."

Section 174(a) provides for the current expense treatment of research and experimental expenditures, and states that this method may be adopted for the first taxable year beginning after December 31, 1953, without consent of the Secretary and at any time with such consent. Once made, the choice must be adhered to in subsequent years unless consent of the Secretary for a change is obtained.

Although Section 174(a) does not expressly require a specific election by the taxpayer in order to utilize the method which it provides, temporary rules promulgated late in 1954 provide for making an election where consent is not required, by attaching to the return a statement indicating "that the taxpayer has elected under the provisions of Section 174(a) (2) (A) to treat all research and experimental expenditures as deductable expenses not chargeable to capital account."

Section 174(b) provides for a specific election to amortize certain research and experimental expenditures. This method is limited to items which are chargeable to capital account, but not chargeable to property subject to depreciation, etc., under Section 167, or to depletion under Section 611.

Under this method the expenditures are treated as deferred expenses, to be allowed "as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures)."

Both elections are subject to limitations set forth in Section 174(c). That makes Section 174 inapplicable to "any expenditure for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under Section 167 (relating to allowance for depreciation, etc.) or Section 611 (relating to allowance for depletion) * * *." Section 167(c) goes on to provide that for purposes of Section 174, allowances under Sections 167 and 611 shall be considered as expenditures.

Section 174(d) makes Section 174 inapplicable to expenditures for finding minerals, including oil and gas.

According to the temporary rules, an election under either Section

174(a) or Section 174(b) is to be made by the time for filing the return, including extensions of such time. An election will be binding for subsequent taxable years unless the Secretary permits a change.

Section 174 presents a number of interesting matters. We may hope that Regulations still unissued even in proposed form will give adequate assurance as to the Service position on them.

One question is whether any election must be made by a taxpayer with an established practice of expensing research and experimental expenditures. It has been suggested by one commentator that the new methods provided cover the field of expensing such items, and that any items not covered by either method must be capitalized. But it seems that this was not intended. The Senate Report did say (p. 215): "Of course, a taxpayer who does not elect to treat research and experimental expenses under the methods provided for in this section may capitalize the full amounts thereof." But that statement seems to have reference only to expenditures which would, but for the new provisions, have been capitalized. By its limitation to items chargeable to capital account, Section 174(b) clearly recognizes that some expenditures have to be expensed regardless of application of Section 174. And the Staff of the Joint Committee seems to have contemplated continuance of established practices, by the statement in its summary (p. 23) that: "Taxpayers not electing to treat research and experimental expenditures under the methods outlined above continue to capitalize them and will continue to receive the same treatment as under prior law."

Pending issuance of Regulations, it may nevertheless be well to attach a statement to the return to the effect that Section 174(a) is to be considered as having been elected if such election be found required to sustain return treatment of research and experimental expenditures.

If the deferred treatment under Section 174(b) is desired, an election should of course be made to that effect. The temporary rules provide for attachment of a statement to the return, which "shall set forth the amounts of each type of such expenditure and the length of the period of which such expenditures are to be ratably deducted."

Those periods are to commence "with the month in which the taxpayer first realizes benefits from such expenditures." Fixing such dates for particular amounts of expenditures with any reasonable degree of accuracy may be impossible. In the words of the Commissioner of Internal Revenue before the Joint Committee on Internal Revenue Taxation on April 4, 1952:

"Many projects take as much as 10 years or more to develop; many are

> unsuccessful; some unpatentable. Furthermore, wholly unlooked for products and processes are often discovered that have no relation to the original project. In large research laboratories many projects are going on at the same time and various scientific and technical men in different lines are working on various phases of all of them at more or less the same time.
>
> "Research and development expenses usually are a necessary part of most businesses. In the past these expenses have consistently been charged to expense by the large majority of such taxpayers. The problem of allocating such expenditures to individual projects, so as to write off amounts applicable to failures, is most difficult and would require elaborate accounting procedures. Over a period of years the deduction of such items as expenditures are made does not appear to create a materially different tax result from the capitalization of all such items and the later allowance of deductions for abandoned or worthless projects and processes and the allowance of depreciation on successful ones."

These and other problems peculiar to application of Section 174(b), including problems of the treatment of patents acquired as the result of research and experimentation, are positive elements of disadvantage in election of Section 174(b) rather than Section 174(a). Moreover, in view of the availability of a five-year loss carry-forward, the deferral of tax consequences under Section 174(b) will usually provide relatively little advantage. In short, it seems that Section 174(b) is a section which will be found useful only in special situations.

Still another question is whether both methods may be used. According to the Senate Report (p. 215), the answer can be yes, on filing of appropriate application for approval in special circumstances.

Changes in Corporate Structure

Tax attributes of one or more corporations involved in corporate changes of various sorts have presented vexatious problems under old law.

Suppose that a corporation underwent a reorganization, so that one or more corporations took over its assets, with its stockholders taking continuing interests in the new corporations. Did that serve to wipe out earnings and profits which would be the source of dividends by the old corporation? From an early date, the answer was no. The answer was derived from general principles of law, and served well enough in most cases.

There arose other questions, as to the other types of corporate changes and other tax attributes. Should a merger be treated in the same way as a divisive reorganization? Should it make a difference if the merger were upstream or downstream? Would the manner of acquisition of stock in one of the corporations be significant? Were cases on earnings and profits good authority on deficits? Should the same principles apply to contested tort liability as to bond premiums and discounts? What should be done about net operating losses? There were many cases, from *Sansome* to *Stanton Brewery* to *California Casket;* and the results of the cases sometimes seemed appropriate to their names.

With respect to rather narrowly defined categories of non-divisive corporate changes, the new Code sets forth in Section 381 a litany of tax attributes and their appropriate treatment.

Section 381(a), which sets up those categories, could be little less lucid if it were in code—with a small c, that is. As I read it, it covers the case of a distribution in liquidation of a subsidiary in which the latter's asset bases carry over and the parent's basis for its stock vanishes—a Section 332 (old Section 122(b)(6)) transaction; except those occurring in two years after purchase of stock over a period of 12 months—Section 344(b)(2) (the statutory version of the *Kimbell-Diamond* rule). It also covers a reorganization transfer which qualifies as a statutory merger or consolidation; a mere reincorporation; or a transfer of all or substantially all the assets of one corporation to another where the transferor distributes all its property, including the stock of the acquiring corporation, to its shareholders pursuant to the plan.

Coverage does not include divisive reorganizations such as spin-offs. And although liquidation of a subsidiary qualifying under Section 334(b)(2) is excluded from coverage, it might conceivably be brought back under coverage by the coverage of a merger. If not so brought back, there will still be questions whether tax attributes will carry over under general notions, as distinct from the convolute provisions of Section 381. For example, earnings or profits might carry over under the old *Sansome* rule even though a merger were held to fall outside Section 381.

Section 381 lists some 19 items. They include net operating loss carry-overs, which are also the subject of specific and rather strange provision in Section 382, and which may call for consideration under the general provisions of Section 269 (corresponding to old Section 129).

Also included are earnings or profits and deficits therein, capital loss carry-overs, methods of accounting, and methods of taking inventories and computing depreciation methods, and others right down to charitable contributions in excess of the prior years' limitations. Various provisions for proration and policing are made with respect to particular items, and it would take longer than I could talk or you tolerate, to cover all of them.

The list is incomplete in a number of respects. Although the carry-over of excessive corporate charitable contributions under Section 170(b)(2) is covered, the carry-over of excessive soil and water expenses in Section 175(b) is not. War loss recoveries under Section 335 and amortization of emergency facilities under Section 168 go unmentioned.

To be sure, the Senate Report says that Section 381 "is not intended to affect the carryover treatment of an item or tax attribute not specified in the section." But many believe that there should be general catch-all provisions which would appropriately ensure preservation of tax attributes for purposes of both the Government and taxpayer.

Conclusion

I suppose no one would maintain that all the provisions I have referred to are perfect in conception and execution. On the other hand, I suppose that many of us think that complete perfection is not only unattainable but perhaps not wholly desirable in practice. A harsh law begets amelioration which in turn invites criticism for complication as well as complaint for incompleteness. Somewhere there must be a stop to search for formal completeness, and a reliance on qualities of good sense and good faith that are such attributes of our professions.

Take Section 381 as an example. Those of us who have ever dealt with Part II of the World War II excess profits tax law know how fantastically complex dealing with even one type of tax attributes can be. There is a good deal to be said from a practical matter for stopping short of complete statutory exegesis. I for one do not expect soon to see the day when a code, however perfect, can eliminate the need for sound common sense, and due regard for considerations of time and circumstance and integrity of transactions and sensibility of results. Those are attributes we find on both sides of the tax table, and must continue to find unless tax affairs are to become shrouded in fogs of formalism, legal logomachy and acrimonious arguments over accounting for the underlying affairs.

SIXTH SESSION

FRIDAY, MAY 20, 1955—12:30 P.M.

Presiding:

HARRY J. TRAINOR, *Assistant Commissioner of Internal Revenue in charge of Inspections, Washington, D. C.; President, Federal Government Accountants Association*

Paper: "A Banker's Viewpoint of the Nation's Economy"

EVERETT D. REESE, *President, Park National Bank, Newark, Ohio; Past President, American Bankers Association*

SIXTH SESSION

Introductory Remarks

Chairman Harry J. Trainor: Ladies and gentlemen, may I have your attention. It is indeed a pleasure to have been selected by the College of Commerce and Administration of The Ohio State University to preside at this final session of the seventeenth annual Institute on Accounting. This honor has not been given to me as an individual, but as the National President of the Federal Government Accountants Association. This organization is only five years old, and it is composed of over 1,700 professionally qualified accountants in 18 local chapters.

These accountants all hold positions in the federal government. We have a potential membership of many thousand, and we are growing rapidly. I am indeed proud of being here as a representative of these accountants in government service.

The gentlemen at the head table have all been introduced to you at one time or another, in this very fine program, so I am going to call their names and ask them to rise and bow, and save your applause, if you please, until they have all had an opportunity to stand.

First, at the head table we have Mr. T. T. Shaw, Mr. John F. Costelloe, Mr. Willard J. Graham, Mr. Robert L. Floyd, Mr. C. R. Fay, Mr. George M. Feiel. I am sure that your presence is greatly appreciated by the audience.

I should like to make one short announcement. I have been asked to state that the meeting of Beta Alpha Psi, for students and honorary members, will be an initiation ceremony held in the Chapel in the Ohio Union Building at 6:15 p.m.

Your program committee has indeed chosen a speaker who is well qualified to cover the broad subject that he has chosen. The nation's economy is of the greatest importance and interest to all of us. Our honored guest speaker, Mr. Everett D. Reese, is a prominent banker, and it seems to me that a banker's viewpoint on the nation's economy would be one of the highest authority.

Mr. Reese is President of the Park National Bank of Newark, Ohio. He graduated from The Ohio State University School of Commerce in 1919. He served as an instructor in the School of Commerce at The Ohio State University, Georgia School of Technology and Tennessee University. Mr. Reese is a past President of the Ohio Bankers Association, and of the American Bankers Association. He is also a member of the faculty of the graduate school of banking, Rutgers University; and a lecturer at the School of Banking at the University of Wisconsin. He is a trustee at Denison University, a Trustee of the Denison University Research Foundation, and of The Ohio State University Development Fund. He is a director of a number of businesses and industries in central Ohio. We are indeed privileged to have Mr. Reese address us on the subject, "A Banker's Viewpoint of the Nation's Economy." Mr. Reese.

A BANKER'S VIEWPOINT OF THE NATION'S ECONOMY

By

EVERETT D. REESE

President, Park National Bank, Newark, Ohio

Past President, American Bankers Association

Mr. Trainor, ladies and gentlemen. It is a real pleasure for me to be here. When Hermann Miller asked me about a year ago if I would be on this program, I very easily and willingly said yes, because that was a year away. How time flies!

First, I want to congratulate The Ohio State University and its officials, and Hermann Miller in particular, on this fine meeting. The combination of education and business is one of the most enlightening and forward looking things that is happening in the United States; and if we have the vision to continue many programs that are going on throughout our country of combining education with practical business, we will continue to make great strides.

It is a pleasure for me to be here, because I have a great regard for accountants, and I have seen in actual practice the many benefits to business of good accounting. It is one of our greatest problems in the banking business, to get good figures from business, and as your profession develops, grows and permeates the whole atmosphere of business, the better job the bankers can do. Many times I have said that a good lawyer, along with a good accountant and a good banker is a combination that makes a valuable ingredient for business.

As I come here, it may be that I can say something that might be helpful, perhaps not in accounting, but generally. We have been especially favored in this country with the privilege of a very widely scattered high standard of living that has spread out to the masses of the people.

Of course, there are many factors involved in that, as to just why we are the favored nation as far as high standards of living are concerned. I think some of the reasons are these: First, we seem to have had a group of people in this country who had vision and courage and willingness to take risks, to look to the future and to go forward, never looking so much to the past, but looking to the future and what might be attempted.

Of course, we were highly favored with varied and plentiful natural resources, widely spread throughout this country, but it takes more than natural resources to create a high standard of living. There are many countries which have rich natural resources that have not been able to have a high standard of living for their people.

Another common misconception is that because we have an increasing population we will necessarily have continued prosperity. It requires more than just numbers of people to create prosperity. Some of the nations with the very largest populations have not had large productivity, which is the basis for the creation of prosperity.

We have had a very fine form of government that has been conducive to progress. Of course, I must say that our free enterprise system, the profit and loss motive in business and freedom of opportunity that people enjoy have been very large factors in creating an atmosphere conducive to bringing out the best in people. It is under such a system that people have an incentive and it has brought out the greatest resourcefulness which encourages people to use their abilities.

We have operated under a system of quite free and open competition which is not a common thing in most of the world. That has put us on our mettle as individuals, one individual competing with another, one group with another, and one product competing not only with a product of a like kind but of many kinds. The people who have made good under this system of competition are those who have been willing to make sacrifices.

From the very beginning of this country there has been a desire on the part of our people to substitute capital for labor, and use capital to make labor more efficient. People have been willing to sacrifice to save money and this money has been used to purchase equipment that would make their work more effective. This idea took hold very rapidly in this country. We first had the use of capital to create what is known as mechanization, and then later on we began to use instruments to make mechanization more effective. Now we are in the era of automation which really is just a continuation of the first two basic ideas. It has taken tremendous amounts of capital to put these processes into effect and this has been made possible by the savings of people. There is no reason why we cannot continue to make progress along these lines. There is still room to increase productivity and further spread the benefits of this production to the masses of the people.

However, our people must understand the real reasons why we enjoy such a high standard of living. An understanding on the part of the majority of our people of the simple principles involved is most important. We occasionally read statements made by some people that automation will put people out of work. Such things were said in England at the beginning of the industrial revolution. There will be adjustments and some maladjustments, but if we are all striving for higher levels of prosperity we must be willing to go through such changes.

In many cases when automatic processes are put in there will be a reduction in costs and lowering of prices, which brings into the market more customers. That process has been going on for a long time and except for temporary setbacks, it has worked successfully—all leading to more things for more people.

During all of the time while the increase in productivity has been going on there has been another movement. There has been a spreading of the benefits of this productivity to larger numbers of people. This has been unique in this country as it has not been the case in many other countries. This broad redistribution of income has been going on at a great rate and this has brought about significant changes in our entire economy. This has put buying power into the hands of the masses of the people.

In the first place, our income in this country has increased from 25 per cent to 42 per cent of the total world income from 1939 to 1953, and, of course, within our own country there has been a great change since 1929. In 1929 the upper 5 per cent of income recipients received 34 per cent of the national income. In 1953 the same upper 5 per cent received only 18 per cent. Of course, if there was an even spread it would only be 5 per cent, but we have gone a long way in the 24 years.

The family group income of $3,000 to $7,500 has increased from 28 per cent in 1939 to 52 per cent in 1953, and in the latter year they received 56 per cent of the total income.

It is also interesting to note the redistribution of income among classes. Of the total of 300 billion dollars national income in 1954, 69 per cent went to employees in contrast with 58 per cent in 1929. Only 3.6 per cent went for rent, in contrast with 6.2 per cent in 1929; 3.2 per cent went for dividends in 1954 in contrast with 6.6 per cent in 1929; 3 per cent went to interest in 1954 in contrast with 7.3 per cent in 1929.

The astounding figure is that the discretionary consumer spending in 1953 was four times that of 1939. It is this redistribution of income that has brought about the tremendous demand for more and better housing, better and fancier automobiles, finer television sets, etc. Our people want nothing but the best.

This has also changed the manner of doing business. In order to do a volume we must cater to the middle group. The carriage trade will not maintain a business today. I am sure that you as accountants are already finding that you are serving many more people than you did a few years ago, and I think this will continue to be the case. Your services will be needed by an increasingly large number of individuals as well as businesses. There are many examples. You will now see such concerns as Tiffany's, and Black, Starr and Gorham advertising articles at quite modest prices along with their high priced items.

The same has been happening in the banking business. There has been a complete transformation in the banking business within a relatively short number of years. To a great extent it is this change in the nature of banking that has brought about bank mergers. The very largest banks in the country which formerly served only large business concerns and wealthier people are now inviting everyone to come in and deposit with them, or borrow from them, and they give consideration to the very smallest loans. Many of the mergers have taken place because a certain bank was not reaching the masses of the people and made an effort to take over another bank that had a system of branches which gave them an opportunity to spread their services. There has been no lessening of competition through bank mergers, but really a strengthening of the competitive forces.

It is interesting to note that The First National Bank of New York, one of the grandest names in banking, sold out to the National City Bank of New York because it had not pursued a course of spreading their services, remaining in one location, and they felt that they could not catch up with the competition. We have now become a personally prosperity-conscious group of individuals and along with the prosperity are demanding more security. It might be said that we are thoroughly spoiled, just as a child who has everything. An authority on alcoholism in describing alcoholism said that it is a compulsory neurosis. Our people have such a compulsory neurosis for prosperity and security.

The business leaders of this country have accepted the task and responsibility to maintain prosperity. Almost without exception they are optimistic and are contemplating only a bright future. They are going ahead with plans for bigger and better plants, and more efficient machinery. There is no spirit of contentment but a drive for more efficiency and higher levels. Our government, and I include both parties, has also assumed the responsibility for the maintenance of high employment, very little unemployment, very high standards of living and a great deal of security for all of us. The least upturn in unemployment creates a demand for government action, and there has been a ready response. There seems to be no turning back from this course.

We are on our way with a tremendous driving force behind us. There seems to be a feeling on the part of the people that if business does not solve the problems of creating high standards of living, the government must do it. You have heard Mr. Philip Sporn, President of American Gas and Electric Company, state that their company will be spending at least $100 million a year to improve their facilities. They must feel that the demand for power will be there when the facilities are built. Research and development programs are being speeded up. There is the combined efforts of business and government working toward the same objectives.

Many years ago the government accepted the responsibility to maintain the high levels of employment and business activity, and has been constantly in the background and the foreground of the entire business picture. The New Deal used easy money as the weapon to counteract high unemployment, and, of course, the war came along and easy money was continued as the means of financing the war as well as creating prosperity. The results were inflation so that the value of the dollar was cut about in half.

The Republicans came in at a time of high levels and had a feeling that inflationary trends should be tempered. An effort was made to put a sounder foundation under the dollar. Interest rates were allowed to rise, one attempt was made to lengthen the debt, and a real effort made to work toward balancing the budget. However, an adjustment was in the making. Inventories had increased to very high levels and installment credit was increasing at quite a rapid rate.

The things that were done by the Republicans helped to temper the extremely optimistic feeling, but when a slight adjustment developed people did not like it, and there was great fear as to just how far the adjustment might go. It might be said that no one liked to face the fact that even a slight downturn might be beneficial to the economy. There was criticism of the government and insistence from many quarters that the government come in and stop the downtrend.

The administration again chose easy money as a weapon to fight the downtrend, so they changed their policies and the policy of easy money was used again; it worked, permeating every phase of our economy, including the housing field. Plenty of funds were provided through reduced reserves for banks and the purchase of U. S. securities by the Federal Reserve. The Housing Act was liberalized and the money made available to carry out the program. No other weapon was used or needed.

We are now back in a very high level of business activity. There is quite a housing boom going on with a tremendous amount of borrowed money being used to finance it. Consumer credit totals are increasing substantially, and the stock market goes booming along. For some little time the government has been trying to temper the rapid rise. The Federal Reserve, for instance, has not put any money into the channels. Margin requirements for the purchase of stock have been raised, and the government has issued some discouraging notices about the market, consumer credit and the housing boom. It is interesting to note that when a boom gets started government measures are not always effective when everyone is in an optimistic mood. The higher margin requirements have certainly not dampened the stock market. Someone asked what the effect would be in raising the discount rate to 1¾ per cent. The reply was made that that would have no more effect than Sally Rand taking off her hat.

Using money as the means to regulate the economy means frequent and quick shifting from restraint to stimulation. Everyone likes the stimulation but restraint is a very unpopular movement. Furthermore, the government is very apt to be behind the situation, not right with it. In the first place, it is hard to diagnose; and secondly, there is always hesitation to put restraint into practice. It is very difficult to shift so fast mentally and be timely. Since 1953 we have had an easy situation, and a tight situation, an easy situation, and again a tight situation.

Bankers are very much involved in the use of money as a weapon to control our economy because money is their business. It is very difficult to be consistent in money lending when money is being used as a means of raising or lowering business levels. The real danger is that we as a people come to think of money control as a one-way street, using it to continue an uptrend of employment and prosperity, but not using it for the purpose of restraint. The popular clamor and demand politically will be to continue pulling the strings with easy money. It is considerably like the use of dope and it takes real courage to resist the pressure not to continue the course once it has been started. Furthermore, the government is prejudiced because it is the largest borrower, and easy money means low carrying charges on its debt. The difference of 1 per cent in interest rates means about $3 billion a year to the government. The pleasant effects of easy money as a stimulant makes good political fodder. The popular thing to do is to keep feeding the streams even though we are at high levels.

There is some thought that money for consumer needs has become too plentiful, and as a matter of fact, merchandise is not being sold today, but terms of payment have become a focal point of sales. I think we should all be interested in the broad aspects of our economy and the welfare of the people as a whole. We as businessmen become too anxious to make the last dollar we can, and could be responsible for the breakdown of our wonderful system of free enterprise. If too many people become too greatly indebted compared with their ability to pay we could help bring a downfall of our entire system. If credit terms to individuals are too easy it will accentuate good business to too great an extent, and it will accentuate our downturns by taking out of the market the masses of the people. This would only lead to stringent controls on the part of the government and legislation to protect debtors.

Consumer debt has risen to over $30 billion. Of course, this is small as compared to the liquid savings of the people in banks, which consists of $73.2 billion; $2.1 billion in postal savings; and $27.5 billion in savings and loans. In U. S. savings bonds there is $58.2 billion, and $71.1 billion in life insurance reserves, or a total liquid assets of $232.1 billion, but a large part of this is probably held by people other than those who owe large amounts for consumer items.

In addition to our social responsibility insofar as business is concerned, I think we need to pay more attention to directing more of our national income to our educational systems. There needs to be more emphasis placed on the salaries of teachers and professors so that teaching will be attractive and the very highest and most competent type of people will come into this field.

There is another obligation that we as businessmen should not ignore, i.e., to help to create a better understanding on the part of the masses of the people as to just why they do enjoy such high standards of living. We live in a democracy and in the end the people will determine our course and it is important that they have a proper understanding of simple fundamental principles. We as individuals should be spending more of our time and effort helping to create that better understanding which will be well repaid.

Let me give you an example. In my travels across the country I ran into one man who has the ability to talk to groups of all kinds, including school children, and to show them exactly what makes our economy tick, helping them understand the reasons for our wonderful privileges that do not just happen, and are not due to the government or what it does. Several of us became interested in Dr. H. C. Young, who has been in the administrative group of the Atlanta Division of the University of Georgia, and we invited him to talk to the high school students in Newark, and at a later date to the Junior high school students. He later appeared at Denison University. He talked to a number of groups at Coshocton, including one labor group.

He tells a simple story, and how little the many privileges that we have are appreciated. He just talks common sense principles and has a tremendous effect on each person in his audience. He has taken a leave of absence from his school and is moving to Granville, Ohio. He will be available to tell his story any place in the United States and if any of you are interested in having his influence felt by a group in your own communities you might contact me. One of the great needs in this country is for our younger people to have an appreciation of the many privileges that we enjoy, and what we must do if we expect to *continue to enjoy* these many privileges.

In conclusion, let me say this: I feel confident that as long as the business people of this country continue with their vision and courage to go ahead with research plans, new buildings, new plants, new machinery, and the process of automation, productivity will continue to increase and the very highest standards of living will be not only maintained but broadened and improved. In addition, we must help to create the proper understanding on the part of the majority of our people as to the basic reasons for our prosperity. We as businessmen also, must have a sense of social responsibility, because to some degree at least, we are our brother's keeper. In this way we can help to preserve the private enterprise system that has meant so much to so many, and we need not be concerned with the continuance of this system if we do our part.

I will close with the words of the old preacher, "Fill my mind with useful stuff and nudge me when I have said enough."

CHAIRMAN TRAINOR: I am sure that you will all agree with me that Mr. Reese has given us many thoughts that we can carry with us. Mr. Reese, we appreciate your fine address, and we consider it as one of the highlights of this Institute.

This is the first time that I have ever attended this Institute on Accounting. I hope I can attend again.

I am sure that this expresses the thoughts of many of us here. Many fine things have been written and said about the annual Institute on Accounting at The Ohio State University.

At the first session, Mr. Floyd referred to the article in the *Accountant Journal* in London of March 1945 that give recognition to the Institute, and placed it on a plane equal to that of other well known international platforms on accounting. I should like to refer to that by saying only that I feel that Mr. Hermann Miller and his associates have lived up to the challenge that this recognition calls for in conducting this very fine and successful program.

With that, the 17th annual Institute on Accounting is adjourned. Thank you.

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* Management Address